INTRODUCTION

This Section of the Handbook presents basic information concerning the mutual and stock form of organization. This section assists in identifying controlling interests in a savings association and in determining the appropriate allocation and exercise of control. This section provides information in the following areas:

- Mutual organization.
- Mutual Holding Companies.
- Types of capital stock.
- Conversions from mutual to stock organization.
- Securities and Exchange Commission (SEC) reporting requirements.
- Insider stock trading.
- Change in control.
- Divestiture of control.
- Contributed capital.
- Capital distributions.
- Employee stock ownership plans (ESOPs).

The Section assists in identifying controlling interests in a savings association and in determining the appropriate allocation and exercise of control.

MUTUAL ORGANIZATION

Savings associations organized as mutual institutions issue no capital stock and therefore have no stockholders. Mutual savings associations build capital almost exclusively through retained earnings. Mutual savings associations may receive pledged deposits and issue mutual capital certificates and subordinated debentures, however, mutuals rarely use these capital forms. When a new mutual savings association organizes, certain founding members pledge savings for the time required for the new mutual to build-up capital and operate profitably.

Background

The first savings associations appeared in the United States in the first half of the nineteenth century. Savings banks first appeared in Boston and Philadelphia in 1816. The first savings association was in 1831 in Frankford, Pennsylvania, now part of the city of Philadelphia. All thrift type institutions were originally mutual institutions. Not until the latter part of the nineteenth century did the first stock savings and loan type thrifts appear. At first, they were only in a few states. Savings banks remained exclusively mutual until the 1980s. All federal savings associations were in mutual form from 1933 to 1974, when Congress amended the Home Owners' Loan Act to permit the conversion of federal mutual savings associations to stock form. The Garn-St. Germain Depository Institutions Act of 1982 first authorized the direct chartering of federal stock savings associations.

Mutual thrift institutions initially were organized by individuals and groups for the common good of working class individuals and families who lacked the financial service facilities necessary for the accumulation of capital through savings plans and access to credit for housing needs. These mutual institutions greatly expanded in number and location throughout the nineteenth and early twentieth centuries. They generally were small institutions, although some eventually grew to substantial size, mostly in the larger cities. Although a substantial number of mutual institutions migrated to stock form savings associations through conversion since the mid-1970s, there remain a substantial core of mutual institutions. There are over 400 mutual savings associations under OTS supervision and several hundred more state chartered savings banks whose federal regulator is the FDIC. These mutual savings associations, while generally smaller than the stock institutions, carry on the basic mission of the founders of the thrift movement. The mutual savings associations remain close to their communities and the immediate needs of their localities for basic banking services for the citizens. In general, mutual savings associations often tend to have higher capital levels, somewhat lower earnings, and high quality assets.

Ownership of Mutual Savings Associations

The concept of ownership in mutual savings associations resulted in extensive discussion and subsequent litigation. The courts have determined that mutual account holders have only a contingent interest in the surplus of mutual savings associations in the event of liquidation. In the first case to challenge the newly adopted conversion regulations of the Federal Home Loan Bank Board, York v. Federal Home Loan Bank Board, the court concluded that conversion to a federal stock organization did not deprive the mutual depositors of property rights.

Members Rights of a Federal Mutual Savings Association

The federal mutual charter grants certain rights to mutual members, which give them some control over the affairs of the savings association. All holders of the savings association's savings, demand, and other authorized accounts are members of the savings association. The ability to exercise control over a mutual savings association by its members, however, is not coextensive with the rights of stockholders of ordinary corporations, although there are similarities. The members of a federal mutual savings association have the right to:

- Vote.
- Amend the charter.
- Amend the by-laws.
- Nominate and elect directors.
- Remove directors for cause.
- Request special meetings.
- Communicate with other members.
- Inspect the corporate books and records.
- Share pro rata in the assets of the savings association following liquidation.

In enacting the Home Owners' Loan Act Congress generally left to the OTS (or its predecessor, the FHLBB) the authority to determine when a mutual savings association's members have voting rights. Except for provisions relating to the conversion of a federal mutual to stock form, there is no statutory requirement that federal mutual savings associations' members have voting rights. Although the charter of a federal mutual savings association does grant such rights, it does not specify a member vote for all significant corporate transactions.

In practice, members delegate voting rights and the operation of federal mutual savings associations through the granting of proxies typically given to the board of directors (trustees) or a committee appointed by a majority of the board.

CAPITAL STOCK

Capital stock consists of stock certificates issued to investors (stockholders) as evidence of their ownership interest in the savings association. One or more individuals or any business entity such as a partnership, a trust, or a corporation may own the stock.

Common Stock

Common stock represents all the basic rights of ownership. Common stockholders exercise their basic rights in proportion to the shares owned. These rights include the following:

- The right to vote for the directors.
- The right to share in dividends declared by the board of directors.
- The right to share in the distribution of cash or other assets, after payment of creditors, in the event of liquidation of the savings association.

Savings associations may value capital stock on their books at a stated par value. A savings association will assign a nominal par value if the stock does not have a par value. Savings associations account for amounts paid in excess of the par value as additional paid-in capital.

The market value of shares does not coincide with par values. The market price reflects many factors, including the following:

- Overall economic conditions.
- Financial health of the savings association.
- Liquidity of the stock.
- Competition.
- Dividend policies.
- Growth potential.
- Market saturation in financial institution issues (supply and demand).

A savings association may list its shares on an organized exchange, or trade them over the counter (OTC). A savings association may act as its own registrar and transfer agent. If the savings association has 500 or more stockholders, the savings association must adhere to the SEC regulations when performing transfer agent functions.

Among the records a stock savings association must maintain is a (registrar's) list of stockholders. The list should include the following information:

- Name of holder.
- Address.
- Number of shares owned.
- Date acquired.
- Certificate number(s) held.
- Amount and type of dividend paid each stockholder.

It is important to promptly record transfers of shares to new owners. Savings associations, periodically, should reconcile the stockholder ledger with the general ledger control account and the stock certificate book.

Preferred Stock

Preferred stock carries certain preferences, such as a prior claim on dividends, over common stock. Often preferred stock conveys no voting rights, or only limited voting rights, to the holders. The articles of incorporation (charter) govern special rights of a preferred stock issue. The chartering authority may also regulate stockholders' rights.

Whether preferred stock is includable in regulatory or generally accepted accounting principles (GAAP) capital depends on its permanence as a funding source. The status of preferred stock as part of capital also depends on whether a savings association is subject to the Securities Act of 1933 and the Securities Exchange Act of 1934. Like common stockholders, preferred stockholders have basic ownership rights and do not have priority over creditors in the event of liquidation.

Although forms of permanent perpetual preferred stock exist, other preferred stock contains defined redemption terms and consequently it is not as permanent or long-term a funding source as common stock.

OTS regulation §563c.102 states that savings associations subject to the Securities Act of 1933 and the Securities Exchange Act of 1934 may not include subordinated debt securities or mandatorily redeemable preferred stock in equity.

Savings associations not subject to federal securities laws financial report requirements may make financial reports using Thrift Financial Report (TFR) instructions and rely on OTS capital regulations. Under 12 CFR Part 567 (Capital), savings associations include noncumulative perpetual preferred stock in core capital (§567.5(a)(1)(ii)). Savings associations include cumulative perpetual preferred stock in supplemental capital (§567.5(b)(1)(i)). Supplemental capital also may include certain redeemable preferred stock and subordinated debt issued under OTS regulations and memoranda. Eligibility for such instruments to qualify as part of regulatory capital depends on the timing of the redemption and other contractual characteristics. See 12 CFR § 563.81, Issuance of subordinated debt securities and mandatorily redeemable preferred stock.

Mutual Holding Companies

The Mutual Holding Company regulation implements § 10(o) of the Home Owners' Loan Act

(HOLA). Part 575 authorizes a mutual holding company to engage in capital raising activities. A mutual holding company may pledge or issue up to 49.9 percent of its post-reorganization stock to persons other than the mutual holding company.

A MHC may create a new subsidiary stock holding company (SHC) that would exist between the MHC and its savings association in a three-tier corporate structure. The SHC, like a stock savings association subsidiary, must issue at least a majority of its shares to the MHC and could issue up to 49.9 percent of its shares to the public. The SHC must own 100 percent of the shares of the savings association subsidiary.

On July 12, 2000 OTS issued an Interim Rule based on the Gramm-Leach-Bliley Act. OTS changed the activities limitations for MHC's to mirror those applicable to financial holding companies. These changes enhance the MHC as a more suitable long-term alternative than full conversion from stock form for mutual savings associations considering conversion.

Subchapter S Corporations

Subchapter S corporations generally receive pass-through tax treatment for federal income tax purposes. The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code that allows financial institutions, and their parent holding companies to elect Subchapter S Corporation status under the Code. The savings association must meet the following criteria:

- Shareholders may only be individuals, certain estates, and trusts.
- There may be no more than 75 shareholders and they must all consent to the election of S Corporation status.
- There must be only one class of stock.
- Must use (or convert to) the specific charge-off method in accounting for bad debts for tax purposes.
- Must use a calendar year, unless IRS grants permission to use some other year.

A Subchapter S holding company may wholly (but not partially) own a savings association that is a Subchapter S Corporation. Thus, holding companies and their wholly owned depository institution subsidiaries are both eligible for S Corporation status.

Savings associations may voluntarily or involuntarily lose their S Corporation status. Although there is no penalty or direct tax for a termination, either a voluntary or an involuntary loss may have adverse effects on a savings association's capital. For example, revocations may adversely affect an association, because the association may need to re-establish deferred tax accounts, which may reduce capital.

Ability to Raise Capital

If an S Corporation needs to raise capital, its initial efforts will often focus on selling additional common stock to its existing stockholders to preserve its tax status. If existing stockholders are unable or unwilling to properly capitalize the thrift, the institution will normally offer to sell common stock to Subchapter S eligible investors who consent to the tax election. The institution should seek to limit the increase in the number of its stockholders to stay within the 75-shareholder limit for S Corporation.

S Corporation stockholders customarily sign shareholder agreements that prevent them from selling stock or otherwise transferring their stock to ineligible stockholders. These agreements typically require a shareholder who wishes to sell stock to first offer the shares to the other existing stockholders before offering the shares to any other party. As a prerequisite to purchasing an S Corporation's stock, a new investor must agree to sign the shareholder agreement.

If the institution cannot successfully increase its capital through these means, it may pursue other potential investors who may cause the institution to lose its Subchapter S election. Alternatively, the institution may have to issue a second class of stock that will result in an involuntary termination of its election. In either case, the institution would not incur any tax penalties because of its return to C Corporation status. Therefore, an institution's tax status as an S Corporation does not prevent it from raising additional capital.

STOCK CONVERSION

For mutual savings associations, conversion to stock form is the avenue available to raise capital in the equity market.

To facilitate the conversion process, management may contract for the services of attorneys, accountants, appraisers, and conversion managers who have conversion experience. Savings associations record conversion sales proceeds after deduction of conversion expenses. In smaller offerings, conversion expenses may amount to as much as ten percent of the equity raised.

Following is a description of various types of conversions. See Part 563b for additional information.

Standard Conversion

A standard conversion offers a funding source for healthy savings associations. In this form, eligible account holders receive nontransferable, pro-rated subscription rights to purchase the stock of the converting savings association before the public offering. Savings associations sell shares of the converting institution not purchased by persons with subscription rights either in a public offering through an underwriter or by the savings association in a direct community offering.

Submission of a conversion plan according to § 563b.3 is the first requirement before effecting a standard conversion. The resulting savings association must comply with the capital standards of Part 567. The accounting used for acquiring assets and liabilities in a standard conversion is generally historical cost of the acquired savings association (pooling-of-interest accounting).

Supervisory Conversion

A supervisory conversion permits savings associations that fail to meet specified capital levels to raise additional capital without government assistance. The resulting savings association must be a viable entity under § 563b.26(b).

Any significantly undercapitalized SAIF-insured savings association will qualify for a supervisory conversion unless OTS determines otherwise. OTS may permit, on a case-by-case basis, an undercapitalized savings association to undertake a supervisory conversion if the savings association can demonstrate that a standard conversion is not feasible. Any BIF-insured mutual savings bank may qualify for voluntary supervisory conversion provided OTS concurs in a certification given by FDIC in accordance with 12 USC 1464(o)(2)(c).

A savings association may accomplish a supervisory conversion through a nonpublic offering (that is, the sale of the savings association's securities issued in the conversion directly to a person or persons).

A majority of the board of directors of the converting savings association must adopt a plan of supervisory conversion that is in accordance with Part 563b. The members of the savings association shall have no rights of approval or participation in the conversion or rights to the continuance of any legal or beneficial ownership interest in the converted savings association.

Merger Conversions

A merger conversion occurs when an existing stock institution or holding company acquires a converting mutual savings association. The converting mutual exchanges its stock for stock of the acquiror. OTS limits merger conversions to cases involving financially weak savings associations. OTS will also consider requests for waivers from this general policy for very small institutions, such as those with assets under $25 million.

Stock Organization

Section 552.2-1 outlines the process for organizing a federal stock savings association. Stock organization means that management decisions are subject to shareholder vote and scrutiny. Stock savings associations must hold annual meetings of shareholders subject to regulatory requirements. These requirements appear in § 552.6 or applicable state law and/or § 14 of the Securities Exchange Act of 1934 (Exchange Act). Savings associations that convert to stock form face increased public disclosure requirements in becoming a public reporting company under that act.

REVIEW OF EXCHANGE ACT AND SECURITIES OFFERING FILINGS

Under § 12(i) of the Exchange Act, OTS has the powers, functions, and duties vested in the SEC to administer and enforce several sections of the Exchange Act for savings associations. The applicable sections are §§ 12, 13, 14(a), 14(c), 14(d), 14(f), and 16. For this purpose, OTS is the securities disclosure oversight regulator for all Home Owners' Loan Act (HOLA) federal charters (both SAIF and BIF members). In addition, OTS is the securities disclosure oversight regulator for state-chartered savings association SAIF members. The FDIC is the comparable regulator for all BIF-insured, state-chartered savings banks.

Approximately 136 savings associations have a class of equity securities registered under the Exchange Act. Therefore, they are subject to Exchange Act periodic reporting requirements and rules governing a wide range of activities. Such activities include proxy solicitations; tender offers; and the acquisition of securities by officers, directors, and significant shareholders. In addition, savings associations that engage in public offerings of securities generally must file an offering circular with OTS. OTS declares the offering circular effective under the requirements of OTS securities offerings regulations for savings associations. These regulations include 12 CFR Parts 563b, 563d, and 563g.

The Business Transactions Division (BTD) of the Office of Chief Counsel and the Accounting Policy Division (APD) of the Office of Supervision review Exchange Act and securities offering filings of savings associations for compliance with the Exchange Act and OTS regulations. The applicable OTS regulations are 12 CFR Parts 563b, 563d, and 563g.

The regional offices are responsible for timely review of filings of savings associations and holding companies for information of supervisory concern. Regional staff should alert Washington to disclosure problems noted during these reviews. For a more detailed discussion of the Washington and Regional Processing of Exchange Act Filings, refer to Appendix B.

Filing Requirements

Controlling persons, such as savings association directors and officers, are potentially liable in connection with their savings association's reports. Directors and officers should ensure accurate filings. This duty to evaluate the completeness and accuracy of reports applies to directors and responsible management officials whether or not they sign the report.

Savings Associations

Section 563d.1 applies Exchange Act rules, regulations, and forms to securities issued by savings associations. As a result, savings associations with a class of equity securities registered under § 12 of the Exchange Act must file various periodic reports with both Washington and the appropriate regional office.

Failure to file timely and accurate Exchange Act reports is a violation of the federal securities laws and applicable OTS regulations. Violations may subject a savings association and its officers, directors, and other related persons to sanctions. These sanctions include:

- Civil suit.
- Cease-and-desist order.
- Civil money penalties.
- Supervisory agreement.

If you note any apparent violations of the Exchange Act filing requirements, report your findings to Washington and the regional accountant without discussing the apparent violations with the savings association. It is very important that any apparent violations of filing requirements be brought to the attention of Washington to ensure uniform interpretation and enforcement of Exchange Act regulations. BTD or APD will contact the savings association and OTS Enforcement, if necessary.

A savings association may become subject to reporting obligations under the Exchange Act in one of four ways:

- Section 12(b) of the Exchange Act requires the registering of any class of a savings association's securities registered on a national securities exchange.
- Exchange Act rules generally require that each savings association with 500 or more shareholders and $5 million or more in assets register its equity securities under the Exchange Act. Savings associations may satisfy this requirement by filing Form 10 with OTS. Also, savings associations may register securities not otherwise requiring registration by filing Form 10 with OTS.
- Section 563b.3(c)(19)(i) generally requires savings associations converting from the mutual to the stock to register the class of securities issued in the conversion under the Exchange Act. Savings associations may not deregister such securities for three years.
- Each savings association, not otherwise required to report under the Exchange Act, has special responsibilities relating to offering circulars filed with BTD. If BTD declares an offering circular effective pursuant to Part 563g, savings associations must make filings pursuant to § 563g.18 with OTS. Savings associations must make these filings for at least the first year during which the offering circular becomes effective. These filings consist of periodic and current reports on Forms 10-K, 10-Q, 10 KSB, 10 QSB, and 8-K as Section 13 of the Exchange Act may require. The duty to file reports under § 563g.18 is automatically suspended for any fiscal year under the following condition:
  - If at the beginning of the fiscal year, (other than the fiscal year the offering circular became effective) the securities of each class to which the offering circular relates are held of record by less than 300 persons.

In addition, § 563g.2 provides that no savings association shall offer or sell any security unless the offer or sale includes an effective offering circular. Part 563g provides for the declaration of effectiveness of offering circulars. In certain circumstances, an exemption from filing requirements is available. Savings associations must file offering circulars required under Part 563g with both BTD and the appropriate regional office.

Savings and Loan Holding Companies

OTS regulation, 12 CFR § 584.1, requires savings and loan holding companies to file Form H-(b)11 with the respective regional offices.

Holding companies with securities registered with the SEC under the Exchange Act must attach certain SEC filings to the H-(b)11. For example, the H-(b)11 must include the following information:

- Proxy material filed with the SEC.
- The annual report on Form 10-K.
- Current reports filed on Form 8-K.
- Any prospectus filed in connection with the public offering of securities.
- SEC reports not excluded by request of the OTS regional office.

Description of Filings

The Annual Report (Form 10-K or Form 10-KSB)

Savings associations must file this report within 90 days of the close of a fiscal year.

The Quarterly Report (Form 10-Q or Form 10-QSB)

Savings associations must file this report for each fiscal quarter (except the fourth quarter) no later than 45 days after the end of the quarter.

The Annual and Quarterly reports provide specific financial information regarding the savings association as well as management's discussion of the savings association's financial condition. The reports also include a description of matters voted on by securities holders, and other relevant matters as required by the applicable form and regulations.

The Current Report (Form 8-K)

Savings associations must file this report with OTS because of the occurrence of the following events and within the following time frames:

- Any changes in control of the savings association - 15 days.
- Acquisition or disposition of assets (of a significant amount other than in the ordinary course of business) - 15 days.
- Placing of the savings association in receivership or conservatorship - 15 days.
- Any change in the savings association's certifying accountant - 5 days.
- Occurrence of other events the savings association deems to be materially important to security holders - no time frame, but within a reasonable time.
- Resignation of directors - 5 days.
- A change in fiscal year - 15 days.

Beneficial Ownership Reports

<u>The Initial Statement of Beneficial Ownership (Form 3)</u>

Those who fall into any of the categories listed below must file within 10 days, Form 3 with OTS.

- Officers.
- Directors (regardless of whether they own any securities).
- Beneficial owners of ten percent or more of any class of the savings association's equity securities.

<u>A Statement of Change in Beneficial Ownership of Equity Securities (Form 4)</u>

Previous filers of Form 3 must file Form 4 when a change occurs in the nature or amount of the person's beneficial ownership of the savings association's equity securities. Filers must file Form 4 within ten days after the end of the month in which a change occurs.

<u>Annual Statement of Changes in Beneficial Ownership (Form 5)</u>

Report annually, within 45 days of the end of the fiscal year, any other small changes in ownership.

<u>The Shareholder Report of Beneficial Ownership (Schedule 13D)</u>

Shareholders must file Form 13D within ten days of the acquisition of beneficial ownership of more than five percent of any class of equity securities. Any material change in the facts of the statement requires that the shareholder promptly (generally within two business days of the material change) file an amendment.

<u>Schedule 13G</u>

Mutual funds and other institutions that invest funds or manage portfolios for beneficial owners must file Schedule G. Filers must file Schedule G within 45 days after the end of the calendar year.

Shareholders must file 13D and 13G reports with the savings association, OTS, each exchange where the savings association's securities trade, or to the National Association of Securities Dealers, Inc. (NASD) if the National Association of Securities Dealers Automated Quotation System (NASDAQ) quotes the stock.

In reviewing Forms 3, 4, and 5 and Schedule 13D, BTD attorneys watch for issues related to Part 574, the potential for hostile takeovers, and possible trading on insider information. You should be alert to these possibilities and alert BTD to relevant information.

Persons own directly any stock held in their own name or held by a bank, broker, or nominee in a street name for their account. Under the convention of holding shares in a street name, a broker executes the trade and holds the stock in the name of the brokerage firm or a nominee. The savings association, through the shareholder (registrar's) ledger, is unaware of the individual initiating the transaction. There are no rules governing the disclosure of ownership held in a street name except for the threshold reporting requirements described above.

Persons are the beneficial owners of any stock that they have the right to acquire through the exercise of presently exercisable options, including options granted through a stock option plan. Indirect beneficial ownership includes stock held in the name of another person if, because of an agreement or relationship, a person obtains benefits substantially equivalent to those of ownership. Such benefits include the right to receive income and the right to control transfer of the stock. For example, a person generally is the beneficial owner of stock in the following situations:

- Stock held by certain family members, such as a spouse or minor children.
- Stock owned as trustee, where the person or members of the person's immediate family have a vested interest in the income or principal of the trust.
- Stock held in trust for which the person is a beneficiary.
- Stock owned by a partnership of which the person is a member.
- Stock owned by a corporation that the person controls.

Proxy and Information Statements

Exchange Act Regulations 14A and 14C require the filing of preliminary copies of all Proxy Statements, other soliciting materials, and Information Statements (used where there is no solicitation of proxies). Savings associations file this material with OTS at least ten calendar days prior to the date of first sending or giving such information to shareholders. Savings associations file definitive copies of the above materials with OTS no later than the date of sending or giving such materials to shareholders.

In certain circumstances, savings associations must provide an Information Statement that contains the information specified by Regulation 14C under the Exchange Act. In those instances where a savings association plans corporate action, the Exchange Act requires the filing of an Information Statement. This is a requirement even where there is no solicitation of proxies. The corporate action may occur either at a meeting of the savings association's security holders or by written authorization or consent of such holders. Savings associations must file preliminary copies of either proxy-solicitation material or an Information Statement, as appropriate, with OTS. Savings associations must submit this material within a specified period prior to any distribution of such information to security holders.

Annual Report to Shareholders

Savings associations must mail to shareholders copies of the Annual Report to Shareholders. Savings associations mail the Annual Report to Shareholders with, or subsequent to the mailing of, either proxy-solicitation material or an Information Statement. The Information Statement relates to an annual meeting, a special meeting instead of an annual meeting, or a written consent instead of either an annual or special meeting that includes election of directors.

Insider Stock Trading

There are substantive limitations on the ability of savings association directors, officers, and ten percent shareholders to trade in the savings association's stock. Any profit realized from any purchase and sale or sale and purchase of the savings association's stock within a six-month period (short-swing trade) is subject to recapture. Either the savings association or the savings association's stockholders by filing suit on its behalf (15 USC § 16(b)) may seek recapture. The rule provides a rigorous guard against misuse of confidential information by insiders. Prohibition, however, does not extend to all reportable transactions.

Furthermore, the Exchange Act generally prohibits directors, officers, and ten percent stockholders from making any short sale of their savings association's stock. That is, any sale of stock that the seller does not then own. The Exchange Act also requires that directors, officers, and 10 percent stockholders deliver to buyers within 20 days any stock they sell. Alternatively, the Exchange Act requires the depositing in the mail within 5 days any stock sold by directors, officers, and 10 percent stockholders.

In addition, Rule 10b-5 under the Exchange Act prohibits a person from trading a savings association's stock using material inside information. Inside information refers to information not available to the public in general (17 CFR § 240.10b-5). The rule also prohibits a person in possession of material nonpublic information from selectively disclosing this information to others (tipping) and generally bars the tippees from trading on such a tip. Information is material for this purpose if a reasonable investor would consider it important in reaching an investment decision or would attach actual significance to the information in making the decision. Thus, savings association officers, directors, and others in possession of material inside information must not trade in the savings association's stock until the information is available to the investing public. Managers must not make any disclosures of material information to selected persons without concurrently releasing the information to the public.

Change in Control

Regulators have concerns about the control of a savings association's voting rights because a change in control may influence the direction and operating policies of the savings association. No person shall acquire control of a savings association through a purchase, assignment, transfer, pledge, or other disposition of voting rights of such savings association without OTS approval. This includes the individual acting directly or indirectly or through or in concert with one or more other persons. OTS rules on acquisition of control of savings associations are in 12 CFR Part 574.

Section 563.181 contains special notification requirements that apply whenever a change occurs in the outstanding voting rights that will result in control (or a change in control) of any mutual savings association. The president or other chief executive officer must report such facts to the OTS. They should file the report within 15 days of their knowledge of such change.

Section 563.183 requires the savings association to file a report whenever there is a change in control of any savings association or holding company and there is also a change or replacement of the chief executive officer within a specified time.

The president or other chief executive officer must file a report when a change in control of a savings association or holding company occurs concurrently with, or within 60 days after or 12 months before, a change or replacement of the chief executive officer. (A change in control also mandates filing Form 8-K for a savings association or holding company subject to public reporting requirements of the Exchange Act.)

The president or other chief executive officer shall report to OTS whether a change in ownership or other change in the outstanding voting rights under §§ 563.181 or 563.183 will result in control or a change in control of the savings association or holding company. Section 574.4 outlines the conditions under which an acquirer possesses control. The regulation also includes conclusive control determinations.

Section 563.181(c) states the conditions that will require a report from a mutual savings association president or CEO when there is a solicitation of voting rights of the savings association. If a solicitation is of a continuing nature, it is necessary to file a report only when the solicitation begins. The report should indicate the continuing nature of the solicitation. No further reporting is necessary unless or until there is a change in the solicitor.

The president or CEO of the savings association or the holding company should file the report required under 12 CFR §§ 563.181 and 563.183. Under 12 CFR § 516.1(c), they should send an original and two copies to the regional office.

Savings associations must provide a business plan with each of the following applications:

- Approval of change in control of a stock savings association.
- Change in control of a mutual savings association.
- Change in or replacement of the chief executive officer.

Willful violations of §§ 563.181 and 563.183 may be subject to harsh enforcement action, including civil money penalties. If you discover such activity, you should remind savings associations and savings and loan holding companies of these reporting requirements. Savings associations and savings and loan holding companies are to resolve any doubt regarding the necessity of filing by submission of a report.

Section 574.4(b) requires reports whenever any person, partnership, corporation, trust, or group of associated persons acquires, receives, or in effect, becomes the holder of ten percent or more of the outstanding stock or voting rights of a savings association.

REGULATORY CONSIDERATIONS

Divestiture of Control

Section 567.13 requires that any acquiror subject to a capital maintenance obligation give prior written notice to OTS if the acquiror proposes divestiture of the savings association.

After receiving the notice, OTS has 90 days to conduct an examination of the savings association. OTS determines the extent of any capital deficiency and communicates the results to the acquiror. If the examination indicates that no deficiency exists, the acquiror may divest control of the savings association upon receiving written notice of the examination results.

If a capital deficiency does exist, any acquiror subject to a capital maintenance agreement may only divest a savings association if they provide OTS with a capital infusion agreement. Such an agreement must provide that the acquiror will infuse the savings association with the amount necessary to remedy the deficiency. Further, the acquiror must arrange for payment, satisfactory to OTS, or otherwise satisfy the deficiency. If the acquiror provides OTS with a satisfactory agreement before the completion of an examination made to determine the extent of any capital deficiency, it may proceed to divest control. Also, the acquiror must arrange for payment, satisfactory to OTS, to ensure payment of any deficiency. Alternatively, the acquiror may immediately satisfy the deficiency.

Contributed Capital

Savings associations may accept without limit the following capital contributions:

- Cash
- Cash equivalents
- Other high quality, marketable assets provided they are otherwise permissible for the savings association.

Savings associations may accept assets that meet the following three-part test and contribute them up to 25 percent of core capital if the association receives prior OTS approval.

- The assets must be separable and capable of being sold apart from the savings association or from the bulk of the savings association's assets.
- Savings associations must establish the market value of the assets on an annual basis. In addition, savings associations must establish the market value through an identifiable stream of cash flows. In addition, there must be a high degree of certainty that the assets will hold their market value despite the future prospects of the savings association.
- The savings association must demonstrate and document that a market exists that will provide liquidity for the asset.

Generally, it is not an accepted practice for savings associations to accept noncash capital contributions other than those outlined above. OTS policy requires that savings associations deduct from assets and capital the contribution of noncash assets that do not meet the above standards for purposes of determining core capital.

Capital Distributions

FDICIA § 38 prohibits an insured institution from taking certain actions if, as a result, the institution would fall within any of the three undercapitalized capital categories. The prohibited actions include the following:

- Declare any dividends.
- Make any other capital distribution.
- Pay a management fee to a controlling person.

See 12 CFR § 565.4(b) and Thrift Activities Handbook Section 120, Capital Adequacy, for guidance regarding the capital categories.

A savings association permitted to make a capital distribution under the prompt corrective action regulations may do so in accordance with 12 CFR Part 563, Subpart E - Capital Distributions. This new rule was effective on April 1, 1999. The revised capital distribution regulation incorporates FDICIA's capital distribution requirements and imposes other limitations comparable to those applicable to national banks.

Subchapter S Distributions

Distributions by a Subchapter S corporation are dividends for regulatory purposes, including prompt corrective action. This includes distributions intended to cover a shareholder's personal tax liability for the shareholder's proportionate share of the taxable income of the institution

OTS may restrict such distributions to shareholders in amount or prohibit them in some instances. There may be some cases where the amount of dividends that shareholders would need to receive to pay their personal income taxes would exceed the amount of dividends allowable under 12 CFR Part 563, Subpart E - Capital Distributions. It is also possible for an association to be generating taxable income in a period when the association is reporting a loss or nominal income for financial reporting purposes. This situation can arise, for example, when an association takes a large provision for loan losses because of credit quality problems but has not yet charged off specific loans.

EMPLOYEE STOCK OWNERSHIP PLANS

It is customary for a significant holder of a savings association's shares to be an Employee Stock Ownership Plan (ESOP). An ESOP is an employee benefit plan. The Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 describe an ESOP as a stock bonus plan, or combination stock bonus and money purchase pension plan. ESOPs invest primarily in an employer's stock, generally by using tax deductible contributions made to the ESOP under the terms of the plan. Other pension plans normally limit the amount of the plan's assets allowable for investment in the employer's securities.

Federal legislation encourages the use of ESOPs to help achieve two major objectives:

- Broadening stock ownership of corporations by employees.
- Providing corporations with an additional source of capital funds.

A plan and trust are the vehicles used to establish an ESOP. The trustee is typically a financial institution. There are over 100 savings associations with trust powers. A savings association with trust powers can be the trustee for its own ESOP and the ESOPs of other employers.

After the establishment of the plan and the trust, the employer periodically contributes to the ESOP. The ESOP uses the contributions to purchase stock of the employer and to pay administrative and other expenses.

A common form of this type of benefit plan is the leveraged ESOP, whereby the sponsoring company forms a tax-qualified ESOP trust. The ESOP then borrows funds from a lending institution to acquire shares of the employer's stock. The stock may consist of outstanding shares, Treasury shares, or newly issued shares.

The debt of the ESOP is usually collateralized by the pledge of the stock to the lender. Also, there is either a guarantee or a commitment from the employer to make future contributions to the ESOP sufficient to cover the debt service requirements. There is a prohibition on the use of guarantees during a stock conversion. In leveraged ESOPs, the employer provides contributions to repay the debt and pay administrative expenses associated with the plan.

A suspense account under the control of the trustee of the plan usually holds the stock shares. Employees receive credit to their individual account when the trustee releases shares from the suspense account. The trustee releases shares from the suspense account as the ESOP repays the loan.

An ESOP must be tax qualified in order for the corporation's contribution to the plan to be tax free. This means the plan must meet certain requirements specified by the Internal Revenue Code and is, therefore, subject to IRS examination. These requirements pertain to participation, vesting, distribution, and other rules designed to protect the interests of the employees.

Recognition of a deferred tax liability may occur if a savings association contributes more than the maximum percentage allowed for deduction in the current year. This allows for an inter-period tax allocation in a future year. Further, ESOPs allow for an above the line deduction for federal income tax purposes. This consists of a pre-tax deduction for employer contributions to the ESOP. The deduction includes both the principal and interest on the loan. Alternatively, if the ESOP is not leveraged, a deduction is allowable for the contribution up to a certain maximum. The net effect of this transaction is a reduction in operating income for the tax year.

An ESOP also may be a non-tax-qualified plan; the corporation simply receives no tax benefits as a result. Attraction or retention of key, highly compensated individuals often involves the use of non-tax-qualified ESOPs.

An ESOP is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and is consequently subject to the rules and regulations promulgated by the Department of Labor.

ESOPs provide the following benefits:

- Employees can acquire stock ownership in their employer without having to invest their own funds.
- The employer can use the ESOP to generate additional capital with tax-deductible dollars.
- Shareholders of a closely held corporation may benefit from creation of a larger market for their stock.

Federal savings associations have the implied authority to establish ESOPs, as they have the authority to compensate their employees. State-chartered savings associations also appear to possess the implied authority to establish ESOPs. This question, however, is a matter of state law. This also holds true for holding companies.

A savings association must establish and operate an ESOP in a safe and sound manner. Section 563.47 requires savings associations establishing employee pension plans to satisfy requirements. Such requirements concern funding, amendments for cost of living increases, and termination. In addition, there are recordkeeping requirements for plans not subject to the recordkeeping and reporting requirements of ERISA and the Internal Revenue Code. The rule is applicable to ESOPs formed by service corporations as well.

A savings association, another financial institution with trust powers, or a service corporation may administer or act as a trustee for an ESOP. Some savings associations have service corporations that are separate trust companies; when this is the case, ESOPs are typically trusteed by those service corporations.

Regulatory Restrictions and Issues

Creation and structuring of ESOPs as an anti-takeover device frequently occurs during conversions. Discussion of three issues of particular interest relating to ESOPs follows:

- An ESOP may purchase no more than ten percent of the stock offered in a conversion.

- Limitations exist in a conversion as to the amount of stock that an individual may purchase and as to the amount of stock that management as a group may purchase. An individual's stock purchase limitations do not include stock held in an ESOP. There is no aggregation of the individual and ESOP stock holdings. Stock held in an ESOP that is a management recognition or retention plan (MRP) is non-tax-qualified. Include stock held in a non-tax-qualified ESOP in determining the overall limitation for management purchases of conversion stock.
- OTS continues to prohibit a savings association, during a conversion, from extending its own credit to finance the funding of any employee stock benefit plan. OTS also prohibits a converting savings association from guaranteeing the debt incurred by the ESOP when it borrows from another lending institution. The major objective of the conversion process is to raise new capital. To permit a savings association to extend financing or to guarantee debt of the ESOP would be inconsistent with that objective. OTS requires a savings association to service the debt of the ESOP and reserves the right to disapprove a plan that is unrealistic in view of historical performance. In addition, substantial conversions could involve violations of ERISA if not done properly.

Transactions with Affiliates

Savings associations are subject to §§ 563.41 and 563.42. These rules restrict and prohibit certain transactions with affiliates. In many cases, ESOPs are affiliates because the trustees are also directors, partners, or trustees of the savings association or its holding company. In some cases, an ESOP is an affiliate because of other control. For example, the ESOP may own, control, or have the power to vote 25 percent of a class of voting securities of the holding company or savings association. If the ESOP is an affiliate, the savings association may not make a loan, guarantee, or other extension of credit to the ESOP. This is because the collateral requirements of § 563.41(c) would be difficult, if not impossible, to meet. The securities issued by an affiliate of the association are not acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of the affiliate.

Despite this limitation, the funding of most ESOPs does not raise concerns. Typically, most ESOPs receive funding by a loan or guarantee from the holding company, as opposed to the savings association itself. A loan by the holding company is not a covered transaction under the affiliate regulations. Refer to Handbook Section 380 for further details on Transactions with Affiliates.

Compliance with ERISA

ERISA imposes complex requirements upon savings associations acting as trustee or in other fiduciary capacities for ESOPs, and severe penalties can result from statutory violations. In addition, the savings association, as the employer or plan sponsor of its own employees' retirement plan, is a party in interest pursuant to ERISA. This is the case whether or not the savings association is the trustee. Almost without exception, all transactions involving the purchase or sale of an asset of the plan to or from the savings association, any affiliate, officer, or employee are subject to the provisions of ERISA. There are only certain narrowly defined exemptions. The plan sponsor or its administrative committee may be subject to reporting, disclosure, and plan design requirements. There are also a number of other responsibilities under ERISA if the savings association is acting as trustee or in a fiduciary or similar capacity.

Risk to Savings Association as Employer or When Acting as Trustee

Most of the responsibility for administration lies with the trustee, and there consequently is little risk to the savings association when it uses an outside trustee. However, the plan and trust establishing the ESOP stipulate the respective rights, duties, and obligations of the employer and trustee. For example, the employer normally keeps records on the number of persons employed. The employer may be subject to liability under ERISA if it violates any of its duties or obligations.

Acquisition of Control

No company, including an ESOP trust, may acquire control of a savings association or holding company without the prior written approval of OTS.

Valuation of Savings Association Stock

Shares of a publicly held savings association where fair market value is recognizable in an actively traded market generally do not raise problems. Difficulties may arise with closely held savings associations; the stock is not marketable and the ESOP creates but a limited market. IRS Ruling 59-60 outlines major principles of stock valuation; one of the principles requires the use of an independent appraiser.

Repurchase Liability

At separation or retirement, employees generally want cash for their shares of stock. The law requires an employer to redeem the shares if there is no readily available market for them. The issue of cash availability can become a critical one for a small, privately held savings association. The ESOP repurchase liability is the savings association's continuing obligation to repurchase its stock from former ESOP participants and their beneficiaries. The savings association should perform a careful analysis of the magnitude of the obligation and include it in the financial planning process if necessary to ensure that enough cash is available.

Accounting

The present accounting for ESOPs comes from a project undertaken by the Accounting Standards Executive Committee (AcSEC), which resulted in Statement of Position 93-6 (SOP 93-6, Employers' Accounting for Employee Stock Ownership Plans). This SOP provides guidance on employers' accounting for ESOPs. The SOP applies to all employers with ESOPs (both leveraged and nonleveraged). It does not address reporting by ESOPs. There is a discussion of financial reporting by ESOPs in the AICPA Audit and Accounting Guide: Audits of Employee Benefit Plans.

The necessity for SOP 93-6 is due to the great expansion in the number of ESOPs, their increased complexity, plus revised laws by Congress concerning ESOPs. In addition, the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL) issued many regulations covering the operation of plans. These actions caused changes in the way ESOPs operate and the reasons for their establishment.

SOP 93-6 brought significant changes in the way employers report transactions with leveraged ESOPs. Although SOP 93-6 did not change how employers with nonleveraged ESOPs account for ESOP transactions, it contains guidance for nonleveraged ESOPs.

The following paragraphs summarize significant accounting rules applicable to employer's accounting for ESOPs.

Leveraged ESOPs

- Employers should report the issuance of new shares or the sale of treasury shares to the ESOP when the issuance or sale occurs. Also, employers should report a corresponding charge to unearned ESOP shares, a contra-equity account.
- For ESOP shares committed for release in a period to compensate employees directly, employers should recognize compensation cost equal to the fair value of the shares committed for release.
- For ESOP shares committed for release in a period to settle or fund liabilities for other employee benefits, employers should report satisfaction of the liabilities when the employer commits to release the shares to settle the liabilities. Other employee benefits include an employer's match of employees' 401(k) contributions or an employer's obligation under a formula profit-sharing plan. The use of an ESOP has no bearing on the recognition of compensation cost and liabilities associated with providing such benefits to employees.
- For ESOP shares committed for release to replace dividends on allocated shares used for debt service, employers should report satisfaction of the liability to pay dividends when the

ESOP commits for the release of shares for that purpose.

- Employers should credit unearned ESOP shares as they commit shares for release based on the cost of the shares to the ESOP. Employers should charge or credit to additional paid-in capital the difference between the fair value of the shares committed for release and the cost of those shares to the ESOP.
- Employers should report dividends on unallocated shares as a reduction of debt or accrued interest payable or as compensation cost. The use of the dividend for either debt service or payment to participants determines the form of accounting entry. Employers should charge dividends on allocated shares to retained earnings. They should make satisfaction of dividends payable by:
  - Contributing cash to the participant accounts.
  - Contributing additional shares to participant accounts.
  - Releasing shares from the ESOP's suspense account to participant accounts.
- Employers should report redemptions of ESOP shares as purchases of treasury stock. Employers should also report redemption of shares of leveraged and nonleveraged ESOPs as purchases of treasury stock. Employers must give a put option to participants holding ESOP shares that are not readily tradable. When participants exercise a put option, employers must repurchase the shares at fair value. The put option requirement applies to both leveraged and nonleveraged ESOPs.
- Employers that sponsor an ESOP with a *direct loan* (a loan made by a lender other than the employer to the ESOP) should report the obligations of the ESOP to the outside lender as liabilities. Employers should accrue interest cost on the debt. They should report cash payments made to the ESOP to service debt as reductions of debt and accrued interest payable when the ESOP makes payments to the outside lender. Apply this rule regardless of whether the source of cash is employer contributions or dividends.
- Employers that sponsor an ESOP with an *indirect loan* (loan made by the employer to the ESOP with a related outside loan to the employer) should report the outside loan as a liability. Employers should not report a loan receivable from the ESOP as an asset and should not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Employers do not recognize in the financial statements contributions to the ESOP or the concurrent payments from the ESOP to the employer for debt service.
- Employers that sponsor an ESOP with an *employer loan* (no related outside loan) should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.
- For earnings per share computations, consider ESOP shares committed for release as outstanding. ESOP shares are not outstanding if there is no commitment for release.

Nonleveraged ESOPs

- Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Measure compensation cost as the fair value of shares contributed to or committed for contribution to the ESOP as appropriate under the terms of the plan.
- Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings. An exception is that employers should account for suspense account shares of a pension reversion ESOP in the manner described in SOP 93-6 for leveraged ESOPs.
- Account for the redemption of shares of a nonleveraged ESOP in the same manner as that required for a leveraged ESOP. Employers must give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to re-

purchase the shares at fair value. The put option requirement applies to both leveraged and nonleveraged ESOPs. Employers should report the satisfaction of such option exercises as purchases of treasury stock. (See the prior discussion of redemptions in the leveraged ESOPs section.)

- Treat all shares held by a nonleveraged ESOP as outstanding in computing the employer's earnings per share, except suspense shares of a pension reversion ESOP. Treat shares of a pension reversion ESOP as outstanding until making commitment for release for allocation to participant accounts. Different rules also apply if a nonleveraged ESOP holds convertible preferred stock.

Consult SOP 93-6 for a comprehensive discussion of rules applicable to employers' accounting for ESOPs.

FOREIGN OWNERSHIP

The Federal Reserve requests that OTS provide information on foreign ownership of savings associations and savings and loan holding companies. You have special responsibilities regarding the foreign ownership of savings associations. These responsibilities include completion of the foreign investment form in Appendix A. Do not include ownership by foreign citizens who have maintained at least five years of permanent U.S. residency. Determine the country of ownership from the highest tier of ownership.

REFERENCES

United States Code (12 USC)

Federal Reserve System

§371c(23A)	Banking Affiliates
§371c-1(23B)	Restrictions on Transactions with Affiliates

Home Owners' Loan Act

§1464(i)	Conversions
§1464(o)	Conversion of State Savings Banks
§1464(p)	Conversions
§1467a(10)	Regulation of Holding Companies
§1468(11)	Transactions with Affiliates

Federal Deposit Insurance Act

§1817(j)	Change in Control of Depository Institutions

United States Code (15 USC)

Securities Exchange Act of 1934

§12	Registration Requirements
§13	Periodical and Other Reports
§14	Proxies
§16	Insiders

United States Code (29 USC)

§1001	Employee Retirement Income Security Act of 1974

Code of Federal Regulations (12 CFR)

FDIC Rules

Part 303 Subpart E	Change in Bank Control

Office of Thrift Supervision Rules

Part 543	Federal Mutual Associations
Part 552	Federal Stock Associations
§561.4	Affiliate
§561.5	Affiliated Person
§563.41	Loans and other Transactions with Affiliates and Subsidiaries
§563.43	Loans to Executive Officers, Directors and Principal Shareholders
§563.47	Pension Plans
§563.81	Issuance of Subordinated Debt Securities and Mandatorily Redeemable Preferred Stock
Part 563 Subpart E	Capital Distributions
§563.181	Reports of Change in Control of Mutual Savings Associations
§563.183	Reports of Change in CEO or Director

Part 563b	Conversions from Mutual to Stock Form
Part 563d	Securities of Savings Associations
Part 563g	Securities Offerings
§565.4	Capital Measures and Capital Category Definitions
§567.5	Components of Capital
§567.13	Obligations of Acquirors of Savings Associations to Maintain Capital
Part 569	Proxies
Part 574	Acquisition of Control of Savings Associations
§584.1	Registration, Examination, and Reports

Code of Federal Regulations (17 CFR)

Securities and Exchange Commission Rules

§240.10b-5	Insider Trading
§240.12b	Registration under the Exchange Act
§240.13	Shareholder and Periodic Reporting
§240.14a	Proxies
§240.14c	Distribution of Information
§240.14e	Tender Offer Rules
§240.16a-1	Reports by Insiders
§240.17f-2	Fingerprinting of Transfer Agent Personnel
§240.17Ad-2	Turnaround of Items by Transfer Agents
§240.17Ad-4	Exempt Transfer Agents
§240.17Ad-11	Reports of Record Differences

OTS Applications Processing Handbook

Section 440 Stock Conversions

OTS Trust & Asset Management Handbook

Section 620 Employee Benefit Accounts

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 47	Disclosure of Long-term Obligations
No. 89	Financial Reporting and Changing Prices

Internal Revenue Service

Revenue Ruling 59-60 Stock Valuation

American Institute of Certified Public Accountants (AICPA) Statement of Position

No. 93-6	Employers’ Accounting for Employee Stock Ownership Plans

Capital Stock and Ownership
Program

Examination Objectives

Identify and determine the nature of ownership and control of the savings association.

Determine whether any individual has exerted a detrimental influence through ownership or control.

Determine if adequate physical safeguards for stock certificates and ownership records are in place.

Determine compliance with applicable laws, rulings, regulations, and any expressed agreements with OTS, FDIC, or state regulators.

Determine the adequacy of the savings association's policies, procedures, and controls related to capital stock.

Review securities filings for information of a supervisory interest and report results of the review to Business Transactions Division (BTD). Include the OTS number in all correspondence.

Determine if a savings association prudently administers an Employee Stock Ownership Plan (ESOP).

Initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note significant violations of laws or regulations other than securities violations.

Examination Procedures

Level I

Wkp. Ref.

1. Determine through discussions with management and other appropriate verification methods, if management has taken corrective action relative to:

   - Prior examination report comments and prior examination exceptions.
   - Internal and external audit exceptions.
   - Any enforcement/supervisory actions and directives.

2. Summarize information from securities offering filings, directors' minutes, audit reports, and other sources pertaining to any new issuance of capital stock (including the payment

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp.Ref.

of stock dividends), notes, subordinated debentures, and other capital instruments. File the information within the continuing examination file (CEF), if applicable.

3. Either you or the regional office should make a brief review of the Forms 10-K, 10-Q, 10-KSB, 10-QSB and any other Exchange Act reports. (See Appendix B.) Compare the Exchange Act reports to TFRs, other reports, information, and documents relating to the savings association that are available. Immediately report any material discrepancies between the disclosures contained in the Exchange Act reports and information known to the regional office. The regional office should inform BTD and the Accounting Policy Division (APD) by e-mail.

4. Carefully review all transactions involving Treasury stock. Determine whether the board of directors' actions adequately supports Treasury stock transactions. Consider whether transactions have a detrimental effect.

5. Update the CEF, if applicable, with the Schedule of Stockholders (PERK 014). Alternatively, summarize the following information for each director and director's interests, officer, attorney, partner, and all other stockholders who own or control five percent or more of the savings association's stock:

   - Number of shares.
   - Percent to total outstanding.
   - Stock certificate number (optional).
   - Issuing price (optional).
   - Date of issue (optional).
   - Confirm the timely reporting of changes in ownership on Forms 3, 4, 5 or Schedules 13D or 13G by companies subject to the Exchange Act.

Exam Date: ____________________
Prepared By: ____________________
Reviewed By: ____________________
Docket #: ____________________

6. Determine stock concentration by noting the total number of shareholders along with the number of shares outstanding. Report foreign ownership to the Board of Governors of the Federal Reserve System. Use the form for Foreign Ownership in U.S. Savings and Loan Associations and Savings and Loan Holding Companies, Appendix A.

7. If the savings association elected S Corporation status since the last examination, perform the following procedures:

   - Review the association's eligibility for the election.
   - Review shareholder agreements regarding stock transfers which management will use to maintain compliance with the eligibility requirements.
   - Verify that management has a method for monitoring ongoing compliance with S Corporation eligibility requirements.
   - Confirm that management periodically test and review the method for monitoring compliance.

8. Review whether the institution has realistic expectations about its ability to increase its capital while maintaining its S Corporation status.

9. Determine whether the association's management and shareholders understand that limitations may exist on the ability of an S Corporation to pay dividends.

10. Determine whether management understands the overall effect of any potential dividend distribution limitations on an S Corporation.

11. Review proxy records from the last election of the directors. Identify anyone who has controlled the election of the board through proxies.

Exam Date: ________________
Prepared By: ________________
Reviewed By: ________________
Docket #: ________________

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12. On the basis of information obtained in procedure No. 5 and review of shareholder and related information, consider:

    - Whether there was a change in control in the association. If yes, determine if BTD received the information, and if not reported, provide details to BTD for a determination of needed disclosures.

    - Whether ownership, or change in control, of the savings association has significantly affected the savings association's operating policies or mode of operations to the detriment of the savings association.

13. ERISA and IRS rules and regulations are complex. Accordingly, you should request the ESOP administrator in the savings association to provide evidence that specialist legal counsel assists in helping to maintain the plan in compliance with all applicable rules and regulations. You should request the ESOP administrator to provide evidence that the savings association is able to meet its repurchase liability. The ESOP administrator also should support the stock valuation of closely held savings associations.

14. From a review of plan documents or other appropriate sources, determine the duties and responsibilities of the savings association regarding its ESOP. Ascertain whether the savings association is satisfactorily performing its duties and responsibilities. If the need for expert advice is apparent, you should recommend that the savings association obtain the advice of an ESOP legal specialist. (*Note:* Section 620 of the Trust & Asset Management Handbook contains additional examination procedures if the savings association or its service corporation is acting as trustee, or serving in a fiduciary or similar capacity.)

15. If the savings association established an ESOP in conjunction with a conversion, determine if the ESOP purchased ten percent or more of the stock offered in the conversion.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

16. Determine if the savings association aggregates stock held in the ESOP with an individual's purchase limitations.

17. Determine if during a conversion the savings association extended its own credit to finance the funding of the ESOP. Also determine if during a conversion the savings association guaranteed the debt incurred by the ESOP when borrowing from another savings association.

18. Determine if the ESOP is an affiliate or an affiliated person. If so, verify that transactions such as loans and other financing arrangements with the savings association are consistent with OTS and FRB restrictions and prohibitions. (12 CFR §§ 561.5 and 563.43 and Federal Reserve Act §§ 23A and 23B.)

19. Determine if an ESOP trust acquired control of the savings association or an S&L holding company. If so, verify OTS approval of the acquisition of control, as required by § 574.3.

20. Summarize pertinent information relating to stock option plans and ESOPs and file in the CEF, if applicable.

21. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

22. Ensure that capital distributions are of the type and in the amount permitted by Part 563, Subpart E – Capital Distributions.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp.Ref.

23. For savings associations subject to the Exchange Act, determine whether the savings association makes timely required filings. If not, contact the regional office or BTD.

24. If the savings association acts as its own transfer agent or registrar, examine the records pertaining to stock certificates to ensure controls are adequate to prevent over issuance of stock.

25. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and recommendations for any necessary corrective measures, on appropriate work papers and report pages.

Examiner's Summary, Recommendations, and Comments

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Foreign Ownership in U.S. Savings and Loan Associations and Holding Companies

Circle one: Announced   Applied   Approved   Consummated

S&L/S&LHC Name & Docket Number:____

Address____

Date of Acquisition: __________________

Citizenship or Country of Incorporation of Investor:____

Investor Name (company number), Address (City and Country) ________________________________

____

Ownership percent (*if controlling ownership)/percent of ownership added:

___________/___________

Source of Information: (circle one)

Securities filing	S&LHC Application	Change of Control Notice
Stockholder Register	Newspaper (send a copy)	Other (identify)

Please attach any additional pertinent information.

This form was prepared by

Name ____Telephone ____________________

OTS Region____Date Prepared _________________

Send this form to:
Brenda Harris, Stop N-401
Micro Statistics Section
Division of Research and Statistics
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave., N.W.
Washington, D.C. 20551

File a copy in the examination workpapers and send a copy to the OTS Director for Financial Reporting, Research and Analysis.

WASHINGTON AND REGIONAL PROCESSING OF EXCHANGE ACT FILINGS

Background

Savings associations must provide full, fair, accurate and complete information regarding their business and financial condition to the investing public to avoid potential liability under the anti-fraud rules of the federal securities laws. It is essential to the supervisory efforts of the regional offices that regulators be aware of critical information disclosed in filings.

The Business Transactions Division (BTD) of the Office of Chief Counsel and the Accounting Policy Division (APD) of the Office of Supervision review Exchange Act and securities offering filings of savings associations for compliance with the Exchange Act and OTS regulations. Also, BTD, upon request, assists the SEC by reviewing filings of savings and loan holding companies referred by the SEC.

Coordination between regional and Washington staff is essential to ensure that savings associations fulfill their obligations to make full, fair, accurate, and complete representations to the public about their financial condition and operations. Reliable public disclosure and market integrity for saving association's securities are key to the savings association industry's capital-raising process.

General Procedures

Each quarter BTD furnishes to the regional offices a list of savings associations registered under the Exchange Act, and the BTD attorney assigned to each association. The specific BTD attorney reviews and examines all of that savings association's Exchange Act reports and any offering circulars it may file.

The regional office should contact the appropriate BTD attorney or an APD accountant whenever questions arise with respect to a particular savings association's disclosure obligations. Also, the regional office should contact BTD by telephone or e-mail whenever information comes to their attention that potentially affects such obligations.

The responsibility for reviewing disclosure documents filed by savings associations for compliance with the Exchange Act and the OTS securities offerings regulations rests with BTD. BTD also is responsible for issuing comment letters relating to a particular filing. Further, BTD is responsible for resolving legal, disclosure, and accounting questions that may arise under the Exchange Act and 12 CFR Parts 563b, 563d, and 563g.

APD performs accounting reviews for the non-transactional Exchange Act filings that contain financial statements. APD is primarily responsible for accounting reviews of the following forms: 8-K, 10, 10-SB, 10-K, 10-KSB, 10-Q, 10-QSB, 12b-25, G-12, applications for conversions, applications for conversions with mergers, and applications for mutual holding company conversions. The BTD staff is primarily responsible for accounting reviews for secondary offering circulars, mergers, and subordinated debt.

Both APD and BTD closely review examination reports and other supervisory communications in connection with their review of securities filings to ensure appropriate disclosures in the filings. APD and the appropriate BTD attorney or supervisor coordinate to secure resolution of novel and precedential accounting issues.

The APD generally issues accounting comments in conjunction with comments issued by BTD on the Exchange Act filings for which it has primary responsibility. Otherwise, BTD provides to the savings association or other filing party all comments relating to the accuracy, adequacy, and timeliness of Exchange Act filings made with OTS. APD and the regional office receive copies of all comments and responses to comments BTD issues. BTD and the regional offices receive copies of all comments the APD issues and reviews.

The APD maintains a shared electronic file of all comments on filings that is accessible by BTD and each regional accountant or a designee. The shared file ensures that each office is aware of each other's findings and can determine if there is a need for a supervisory response. BTD, APD, and the regional office must be aware of problems that require disclosure in filings. The latter must also be aware of BTD and APD comments, and responses to those comments.

BTD (and APD as appropriate) will resolve all issues regarding a savings association's compliance with BTD and APD comments. Also, BTD will resolve any necessary enforcement or other actions regarding compliance with filing requirements. In some instances, BTD or APD may seek the assistance of a regional office in obtaining savings association compliance with comments.

BTD and APD must rely on regional regulators to observe and report events that may affect Exchange Act disclosures, particularly events raising significant supervisory concerns. Regional regulators, therefore, must have a general knowledge of the content of a savings association's securities filings.

Time Requirements

For a report to be timely, OTS must receive a properly filed report by the required date. The mailing or postmarking of a report on the last day on which a report is to be filed does not constitute a timely filing.

A savings association may receive an extension of time to file a report if the savings association follows the procedures described in the regulations and satisfies all of the requirements of an extension. Exchange Act Rule (17 CFR § 240) 12b-25 contains general provisions to follow if a savings association fails to file within a prescribed time frame all or portion of an Exchange Act periodic report. If a savings association fails to submit a complete required Exchange Act periodic report within the prescribed time period it must file a Form 12b-25. The savings association must file Form 12b-25 no later than one business day after the due date of such report. The association must disclose its inability to file the report on a timely basis and the reasons why in reasonable detail, and otherwise comply with all other requirements of Rule 12b-25. Among other things, the savings association must represent in the Form 12b-25 that it cannot eliminate the reasons for the delay without unreasonable effort or expense. The savings association also must represent that it will make the filing within the period of the extension.

Rule 12b-25 provides for a 15-day extension for a Form 10-K or 10-KSB and a 5-day extension for a Form 10-Q or 10-QSB. Such extensions are available only upon an appropriate filing with BTD. They are available only for one 15- or 5-day period as appropriate for the type of filing and, as such, no additional extensions of time are available under the regulations.

If appropriate, a savings association may represent its failure to file a timely prescribed report because it is unable to file the report without unreasonable effort or expense. Generally, late reports satisfy prescribed due dates only if the savings association meets all conditions of the rules.

When a savings association is unable to file a report on time, it should promptly consider its general public disclosure obligations. The savings association should determine whether it is appropriate to issue a press release to advise its stockholders and the public markets of material information pertaining to the savings association. The savings association should file late material under cover of Form 8-K. In this regard, savings associations may wish to contact BTD or submit a written statement of the reasons for the delinquency. The statement should include a description of the steps the savings association is taking to come into compliance with the reporting requirements.

Regional Procedures

Securities oversight of savings associations is critically important. Regional regulators must alert the BTD attorney responsible for the particular savings association in question, to all supervisory or other regulatory information that affects or may potentially affect securities law disclosure obligations. This reporting may be through e-mail. The use of e-mail provides more time for both the regional and BTD reviews. Also e-mail facilitates the maintenance of the comments in a shared electronic file that is available to the regions, BTD, and APD.

The regional office should provide to the appropriate BTD attorney and APD copies of all nonroutine correspondence to and from the savings association. Further, the regional office should provide copies of documents and internal memoranda that may contain information relevant to a savings association's disclosure obligations. The BTD attorneys and APD review this information to ensure that savings associations promptly comply with all disclosure obligations.

Achievement of successful supervision of savings association securities responsibilities requires uniformity and consistency of action. Regional personnel and BTD shall coordinate supervisory approach prior to initiating discussions with savings associations regarding requests for additional information or requiring corrective action under the Exchange Act. Should it become necessary, BTD will inform Enforcement of Exchange Act or securities offering problems needing enforcement attention.

Regional office personnel are responsible for contacting holding companies that are not filing Form H- (b)11 as required. The inclusion of SEC filings in Form H-(b)11 does not mean that OTS necessarily has a role in performing disclosure review of those documents. Regional regulators should provide any comments to BTD for all securities filings that the holding companies provide and send BTD related correspondence and examination reports upon request.

Regional personnel also should refer all comments or discovery of material information regarding savings and loan holding companies that are subject to Exchange Act filing requirements to BTD. BTD and APD will assess the materiality of the information for purposes of securities law obligations and will work with the regional personnel in deciding an appropriate response under the circumstances. BTD and APD also will assess the information to determine whether a referral to the SEC is appropriate.

You should report information concerning accounting or reporting problems that may affect the Thrift Financial Report (TFR) to the Financial Reporting Division (FRD), Dallas, TX. The staff of the FRD in Washington, DC can answer questions and provide advice concerning the correct completion of TFRs. Institutions may correct TFRs that are less than five months old.

The regional office should determine if savings associations provide timely periodic Exchange Act filings. The regional office should maintain a schedule for each regional Exchange Act registered savings association indicating the due dates of all Exchange Act filings. This Handbook Section lists all common required filings and their respective time requirements. Regional offices should use this information to set up the schedules. BTD and the APD maintain similar schedules and may assist the regional offices in setting up these schedules.

Savings associations must file required reports within prescribed time frames. Before the regional office contacts a savings association to inquire about a missing filing they should first check with the assigned BTD attorney to determine if BTD has the filing. In certain instances a savings association may explain a late filing by filing Form 12b-25. Depending on circumstances, this filing may allow a short extension of time to file certain reports. In addition, a savings association may inadvertently file reports with either BTD or the region, but not both. In such a case, BTD will direct the savings association to immediately file reports as required by the regulations, including Parts 563d and 563g.

Failure to file required reports on a timely basis may indicate deeper problems at a savings association. When regional regulators become aware of serious problems with a registrant savings association, they should immediately alert the BTD attorney and the APD by e-mail.

Regional staff should quickly and promptly review all filings related to savings associations and holding companies to discover any information of supervisory interest. Regional staff should not rely on BTD for this supervisory review. Further, regional staff should not duplicate the work of BTD in reviewing filings for compliance with the Exchange Act and Parts 563b, 563d, and 563g of the OTS regulations. If regulators read the filings promptly they may find serious problems disclosed in filings months before they would otherwise find them. A quick and timely review of filings may result in more timely initiation of a supervisory response that may require a restatement of earnings and financial position. In addition, the timely review of filings may lead to enforcement action such as cease and desist, removal and prohibition, or receivership.

After a review of any filing, regional personnel should prepare a brief memorandum to BTD and the APD describing the review and any related problems. The regional office should promptly provide this memorandum via e-mail to BTD and APD who will include the information in the shared electronic file. If necessary, BTD and APD will prepare and issue a comment letter concerning disclosure problems to the savings association.

The regional office prepares a memorandum to inform BTD and APD that a review is complete. Also, if pertinent, the memorandum discloses the possible existence of supervisory concerns and corrective actions that the regional office recommends. If the regional office notes problems, the filing will receive high priority. In the absence of problems noted, the filing will likely receive a lower review priority.

When a savings association files an offering circular pursuant to Part 563g, BTD generally issues an initial comment letter on the filing within 14 calendar days of the filing date. This comment letter will generally include comments from the BTD attorney assigned to the savings association. Accordingly, regional staff should review offering circulars and provide any relevant information via e-mail to BTD within ten calendar days of filing. Satisfying this time frame will allow BTD to consider such information within the initial review period.

Critical to an effective OTS oversight role is the certainty that regional personnel are thoroughly familiar with the current financial and operational condition of savings associations. Knowledgeable regional personnel promptly review filings for supervisory concerns, and communicate any concerns to BTD and APD. A critical component in BTD's Exchange Act oversight role is ensuring correction, as soon as possible, of any information in a public filing that is inaccurate, misleading, or incomplete. For this reason, regional regulators should promptly review upon receipt — Exchange Act filings, offering circulars, and applications for conversion. Regional personnel should provide relevant supervisory information to BTD and the APD when practicable, rather than wait until completion of the next examination report.

Regional regulators also should be aware of significant events that have occurred requiring the filing of a current report on Form 8-K. The regional directors also should determine if the filing is timely. Consult with a BTD attorney if there is question regarding the necessity of making a filing.

Filers must properly file and receive BTD clearance of proxy-soliciting materials, (or information statements, when applicable), before distribution to stockholders. Regional regulators should note these required steps. In addition, while not necessary, regional regulators may review proxy materials. If they do review proxy material, they should notify BTD and APD immediately by e-mail if they believe any proxy documents contain a material misstatement or omit any material information.

Regional regulators should also be alert to changes in the majority of a savings association's board of directors resulting from actions other than a meeting of the stockholders. Regional regulators should promptly consult with BTD if questions arise regarding a change in the majority of a board of directors. Also, regional regulators should immediately notify BTD should problems arise.

Regional regulators should identify any savings associations with assets of more than $5 million that have 300 or more shareholders and a class of stock not registered under the Exchange Act. Also, regional regulators should identify formerly registered savings associations. Interpretive questions sometimes arise as to the meaning of "held of record" or "class" and regional regulators should refer these questions to BTD. If it appears that a savings association should have registered its stock under the Exchange Act, the regional office should advise BTD. The trigger for this inquiry is 300 shareholders because:

- Although 500 shareholders triggers registration under the Exchange Act, the number of shareholders may have increased to 500 or more since the last verification.
- Three hundred shareholders triggers deregistration.

Finally, regional regulators should notify savings association officers and directors of their responsibilities to file reports (with BTD in Washington and the regional office) relating to their ownership in the savings association's securities. The rules in this area can be extremely complex and there is a large body of judicial precedent dealing with this area. Refer questions regarding interpretation to BTD. Savings association officers, directors and five percent or greater shareholders have ownership and transaction reporting requirements under the Exchange Act. The Exchange Act requires this information on Forms 3, 4, or 5 and Schedule 13D or 14G. Regional regulators should encourage those under obligation to file to consult with their own counsel regarding their filing responsibilities.

A critical component to the implementation of a quality securities oversight function is that any material information on a particular savings association be transmitted to BTD as soon as possible. Regional regulators should contact the appropriate BTD attorney and APD accountant to report information or discuss disclosure issues as needed. Initiate contact while an examination is ongoing, or anytime, not just at the completion of the examination report.

Section 563d.2 of the OTS regulations requires savings associations to file with BTD six copies of certain reports and related correspondence. Savings associations must also file one copy of the report and related correspondence with the appropriate regional office. BTD provides a copy of the reports to the APD.

INTRODUCTION

One of the most important objectives for regulatory personnel is to evaluate the adequacy of a thrift's capital. The level of capital maintained bears heavily on the overall condition of the thrift. Capital provides protection to depositors, creditors, and the Federal Deposit Insurance Corporation (FDIC) insurance fund. It is important in maintaining public confidence in individual thrifts and the entire financial system. Capital allows thrifts to absorb unexpected losses and remain viable. The level of capital should be commensurate with the risks a thrift assumes and should be sufficient to provide for future growth.

The Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), require the federal banking agencies to impose mandatory sanctions on undercapitalized institutions and authorizes the agencies to impose prescribed and discretionary sanctions on significantly undercapitalized institutions. FDICIA also establishes the presumption that critically undercapitalized savings associations will be placed into receivership or conservatorship.

This Section of the Handbook offers guidance for ascertaining whether a thrift has policies and procedures for determining and maintaining an adequate level of capitalization.

Capital Planning

Capital planning is an important aspect of management. Managers and directors should attempt to anticipate capital needs and provide for the maintenance of adequate capitalization. Although regulatory requirements establish minimum capital requirements for thrifts, well-managed thrifts typically operate with capital in excess of these requirements. The board of directors should target a minimum capital level for the thrift consistent with its risk profile.

Good capital planning is dynamic. Management should formulate plans for the growth, mix, concentration, and effective management of assets and liabilities. A good plan sets forth specific strategies by which management intends to achieve established goals. Strategies that may be used to increase capital include:

- Changing the mix of assets and liabilities toward a less risky orientation;
- Reducing asset size or slowing asset growth;
- Increasing earnings retention through the reduction of dividend payments;
- Improving profitability;
- Issuing capital securities (e.g., common or preferred stock), subordinated debt or mandatory convertible debt;
- Converting from mutual to stock form; and
- Merging.

PCA requires the OTS to order undercapitalized savings associations to undertake one or more of these actions and provides express authority for OTS to require savings associations to undertake other remedial or prudential actions.

Capital plans submitted due to capital standards failure must satisfy certain requirements. Capital plans under the Home Owners' Loan Act of 1933 (HOLA), and "Capital Restoration Plans" under PCA (collectively, "capital plans"), may be separate documents or part of a thrift's overall strategic business plan. These are discussed in the Thrift Bulletin (TB) 36 series and in the PCA discussion later in this chapter.

Capital Adequacy Factors

Both in capital planning by the thrift and in regulatory analysis, careful consideration should be given to the factors that may affect capital adequacy. Capital adequacy cannot be determined solely on the basis of a numeric formula or standard. Regulatory minimum capital requirements are not a proxy for analysis of the adequacy of an institution's capital position. This philosophy was officially recognized within the thrift industry in conjunction with the passing of the Competitive Equality Banking Act of 1987 (CEBA), and the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), in which the Congress explicitly gave OTS the power to exercise discretion with respect to imposition of higher required capital levels for individual thrifts.

The following factors should be viewed in conjunction with an overall analysis and understanding of the thrift, as well as of financial institutions in general. However, the list is by no means all-inclusive. It is intended to give the reader an overview, rather than provide an exhaustive study. Following is a brief discussion of each of the major factors that influence the need for capital.

Supervision and Administration by the Board of Directors and Management

The effectiveness and quality of associations' managers and directors are key factors in evaluating capital adequacy. Together, the managers and directors must ensure that the thrift has the procedures, policies, and internal controls and reporting systems necessary to provide for the safe and sound operation of the thrift. The board of directors must ensure that the thrift has competent managers. The board of directors and management should work together as a team, but they must also understand their distinct roles and responsibilities. The directorate remains ultimately responsible for the conduct of the thrift's affairs and provides independent checks and balances over management.

Earnings Performance

Profitability is a fundamental component of capital analysis, as it is a key indicator of the extent to which retained earnings can be relied upon as a source of new capital. Retained earnings are affected by profitability and dividends.

Earnings performance should be sufficient to support the maintenance or growth of capital commensurate with the thrift's asset growth goals, balance sheet composition, and overall operating policies. It is as important to evaluate future earnings' potential as it is to evaluate past performance. The regulator should be sensitive to the stability and quality of the earnings stream, and to bottom-line performance.

Balance Sheet Composition

The amount of capital required is a function of the risks associated with the composition and mix of assets and liabilities. The need for capital correlates to the risk inherent in the specific assets and liabilities, and to the use of assets and liabilities in selected business strategies.

Off-Balance-Sheet Activities

Off-balance-sheet activities should be examined to determine risk exposure and risk concentrations. Each source of risk must be viewed in light of its contribution to portfolio risk and the ability of management to administer it. It is important for management to be aware of these sources of risk, including the association's credit risk exposure under recourse obligations. Management must implement controls and procedures to identify, monitor, and manage the corresponding risks. Major off-balance-sheet risks include credit, interest-rate, and market risks, as well as pending litigation.

Asset Quality/Credit Risk

The overall mix of risks in assets composing the balance sheet is a key determinant in evaluating capital adequacy. One must also consider the extent to which individual assets exhibit serious weaknesses or potential loss of value. An indicator of asset quality problems is the amount of assets subject to adverse classification and the relative severity of those classifications in relationship to capital. Delinquency and foreclosure trends, the level of nonaccrual or nonperforming loans, bond ratings, and market depreciation of securities also are indicators of asset quality. Specific consideration should be given to the future effect on capital of continuing asset quality problems and the effectiveness of portfolio (loan and investment) management.

Asset/Liability and Liquidity Management

Asset/liability and liquidity management encompass the management of the relative composition of the balance sheet accounts. Institutional objectives should be accomplished without exposing the thrift to unduly high levels of interest-rate risk, while maintaining adequate levels of liquidity. The directorate must also ensure that its asset/liability guidelines address off-balance-sheet accounts.

Growth Trends and Goals

Growth in assets should be supported by growth in capital. Asset growth that outpaces the ability of the thrift to maintain a sufficient level of capital is unsafe and unsound. Growth must be undertaken in an environment where management can sufficiently plan for the thrift's soundness and provide adequately for additional capital needs.

Service Corporation and Other Subsidiary Activities

Generally, service corporations and other subsidiaries should be capitalized commensurate with industry standards for the activity in which they are primarily engaged. The capital regulation, Part 567, requires deduction from assets and capital of debt and equity investments of thrifts in subsidiaries [per definition in § 567.1(l) and (dd)] that are engaged in activities that are impermissible for national banks. The assets of other subsidiaries are consolidated with the assets of their parent association in calculating the parent's capital requirement on a consolidated basis.

Savings and Loan Holding Company Activities

The policies and practices of holding companies can significantly affect the operations of the thrift subsidiaries. When a thrift operates within a holding company structure, it is critical that supervisory personnel ensure that thrift dividend policy, tax sharing, consulting fees, and other transactions with the holding company do not lead to an unsafe or unsound condition for the thrift.

Unsafe and unsound financial and operating practices include the siphoning of excessive funds from the thrift by the holding company (possibly to aid another subsidiary) and other intercompany transactions that may not be in the thrift's best interest. Refer to the OTS Holding Companies Regulatory Handbook for further discussion.

Capital Distribution Policy

Dividends are distributions of earnings to owners normally paid in the form of cash. Stock dividends have no effect on the corporation except to increase the number of shares outstanding. During profitable periods, dividends represent an appropriate return of net income to shareholders. However, the payment of cash dividends that are not fully covered by earnings may be inappropriate when circumstances indicate the need to strengthen capital.

It is inappropriate for a thrift with serious financial problems or inadequate capital to borrow in order to pay dividends, as this may increase leverage at the very time the organization needs to reduce its debt or increase its capital. Similarly, dividend payments based solely or largely upon gains from unusual or nonrecurring events, such as the sale of the organization's building or the disposition of other assets, may not be prudent or warranted. The board of directors should establish prudent dividend policies relative to a thrift's financial condition and compliance with regulatory capital requirements. Once established, the policy should be reviewed periodically.

The capital distributions regulation, 12 CFR § 563.134, controls the payment of dividends and other capital distributions. In general, the regulation implements a differential regulatory approach keying the capital distributions by thrifts to their capital levels.

Pursuant to § 567.10 and § 563.134, capital distributions are restricted if a thrift fails to meet its Part 567 capital standards. PCA provisions of Part 567 also prohibit, with minor exception, the making of capital distributions by undercapitalized associations.

Furthermore, a stock thrift with outstanding net worth certificates cannot pay dividends to its shareholders.

Capital Ratio Analysis

Financial ratio analysis should be used to supplement qualitative analysis of the capital adequacy factors. Analysis should consider not only the static relationship reflected by the ratio, but also a comparison with peer group ratios. A study of the key ratios over periods of time may be useful. The following ratios may be useful in evaluating the thrift's capital position.

1. Equity capital/total assets

2. Tangible capital/tangible assets

3. Core capital/adjusted tangible assets

4. Total capital/risk-based capital requirement

Ratios 1 through 4 indicate the extent to which capital is leveraged. By analyzing these ratios, a clearer picture of the stability and safety of the thrift can be obtained.

5. Asset growth rate

6. Capital growth rate

7. Liability growth rate

Ratios 5 through 7 are growth rates of three balance sheet components. They should be viewed together and their interrelationships examined.

8. Total classified assets/tangible capital

9. Allowances for losses/total classified assets

10. Allowances for loan losses/total loans

Ratio 8 reflects the extent to which capital is supporting problem assets. Ratio 9 reflects the recognition of risk in the level of allowances established against classified assets. Ratio 10 reflects the level of allowances established against the loan portfolio.

Capital Standards Required By Law

On August 9, 1989, the FIRREA was enacted. Section 301 of the FIRREA amended the HOLA by adding a new section, 5(t), that required the OTS to establish uniform capital standards that require thrifts to satisfy three separate tests: a tangible capital standard, a leverage ratio (core capital) standard, and a risk-based capital standard. OTS capital standards must be no less stringent than the capital standards applicable to national banks. The OTS capital rule generally parallels the risk-based capital standards of the federal banking agencies and is consistent with the Basle Accord adopted in 1988.

The statute requires OTS to use the same relevant substantive definitions as the OCC in these capital standards, with certain exceptions where the statute itself defines terms. The statute contains specific provisions mandating the regulatory treatment of Qualifying Supervisory Goodwill (QSG), purchased mortgage servicing rights (PMSR), and certain subsidiaries of thrifts, including certain transition provisions. The statute also sets forth certain consequences of failure to meet these capital standards and allows thrifts to apply for exceptions and exemptions from some of these consequences.

PCA provides for the imposition of additional mandatory, presumed and discretionary sanctions for undercapitalized institutions with the severity of the consequence depending on whether the institution is significantly undercapitalized or critically undercapitalized. See the discussion of PCA below.

Section 305 of FDICIA requires OTS to review its risk-based capital standards to ensure that those standards take adequate account of interest-rate risk. In August 1993, OTS added an Interest-Rate-Risk Component to its risk-based capital standard (effective date January 1, 1994). See the discussion of the Interest-Rate-Risk Component below.

Outline of Capital Regulation (Part 567)

HOLA 5(t), [12 USC 1464(t)], requires OTS to promulgate regulations prescribing uniformly applicable capital standards for all thrifts. These regulations are codified at 12 CFR Part 567.

- § 567.1 contains definitions of terms used in the capital standards. These definitions are supplemented with definitions in the Thrift Financial Report (TFR) Instruction Manual. This Handbook Section follows the terminology of the TFR and uses upper case lettering to designate TFR terms.
- § 567.2 sets forth the three capital tests that thrifts must satisfy.
- § 567.3 and 567.4 set forth the Individual Minimum Capital Requirements and Capital Directives.
- § 567.5 contains the permissible components of a thrift's available total capital.
- § 567.6 contains the credit risk-weight categories that are used in determining a thrift's risk-weighted assets.
- § 567.7 sets forth the interest-rate-risk (IRR) component used in calculating a thrift's risk-based capital.
- § 567.8 contains the leverage ratio (Core Capital) requirement.
- § 567.9 sets forth the Tangible Capital requirement and the calculation of the available Tangible Capital base for this requirement.
- § 567.10 contains the statutorily mandated consequences of a thrift's failure to meet any of its regulatory capital requirements.
- § 567.11 reserves certain authority for the OTS to disregard evasive transactions, requires calculation of ratios on an average basis, and makes exceptions to some definitions.
- § 567.13 sets forth the obligations of acquirors to maintain capital.

Capital Standards Overview

Part 567 establishes three standards that a thrift must satisfy to meet its capital requirements:

(1) a tangible capital standard ("Tangible Capital requirement");

(2) a leverage ratio standard ("Core Capital requirement"); and

(3) a risk-based capital standard.

<u>Tangible Capital</u> includes items of a generally permanent nature such as equity and retained earnings less intangible assets.

<u>Core Capital</u> includes Tangible Capital and qualifying intangible assets. The definition and treatment of qualifying intangible assets is discussed below.

<u>Supplementary Capital</u> includes other capital items providing a lesser degree of protection due to their nonpermanent nature or their imposition of fixed obligations. The amount of Supplementary Capital that may satisfy the risk-based capital requirement is limited to the amount of Core Capital. Additional limits are placed upon certain types of Supplementary Capital, such as hybrid capital instruments that have some characteristics of both debt and equity, and General Loan and Lease Valuation Allowances (GVA).

<u>Total Capital</u> equals the sum of Core Capital and Allowable Supplementary Capital less Assets Required to be Deducted, less IRR component.

Calculation of both required and available capital follows TFR accounting and regulatory definitions. The TFR Schedule Consolidated Capital Report (CCR) is a useful guide to the capital calculations.

The capital regulations include a number of transition provisions that are detailed in the text following this discussion of the capital standards. Due to related limits on some figures, this calculation sequence may be helpful: First, consolidate a statement per TFR instructions to determine consolidated Total Equity Capital and consolidated Total Assets. These figures are reported on TFR Schedule Consolidated Statement of Condition (CSC). Calculate Tangible Capital and Tangible Assets. Then calculate Adjusted Tangible Assets and Core Capital. Finally, calculate risk-weighted assets, Allowable Supplementary Capital, Adjusted Total Capital, and the Risk-Based Capital Requirement.

Tangible Capital Standard

This standard requires Tangible Capital of at least 1.5% of Tangible Assets (including qualifying PMSR). Tangible Capital may be calculated by adjusting consolidated GAAP Total Equity Capital. Tangible Assets may be calculated by adjusting consolidated GAAP Total Assets. Tangible Capital includes:

- common stockholders' equity,
- additional paid-in capital,
- retained earnings,
- noncumulative perpetual preferred stock (less contra accounts such as shareholder receivables),
- pledged deposits,
- minority interests in the equity accounts of consolidated subsidiaries, and
- unrealized gains and losses on available for sale securities (see discussion of FAS 115 below). The deduction of certain assets from assets and capital set forth under tangible capital also carries over to calculation of core and total capital. The primary adjustments required to calculate Tangible Capital and Tangible Assets are discussed below.

Equity

Common stockholders' equity is a permanent, or nonmaturing, source of funds. Noncumulative perpetual preferred stock differs from common stockholders' equity primarily in that the issuer has a fixed requirement to pay dividends and the stock has no maturity. The obligation to pay dividends can be suspended when the thrift encounters financial difficulties. (Preferred stock issued by a thrift or a subsidiary that is effectively collateralized by assets of the thrift or one of its subsidiaries is not considered part of capital, regardless of its cumulative or noncumulative characteristics.)

The Financial Accounting Standards Board (FASB), on May 31, 1993, issued a new statement, SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities" that changed the accounting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. A major effect of SFAS No. 115 is to include unrealized gains and losses on "available for sale" securities as common shareholders' equity under GAAP. Institutions are required to follow SFAS No. 115 for fiscal years beginning after December 15, 1993. OTS and the other federal banking agencies adopted SFAS No. 115 for reporting purposes as of March 1994 and will permit associations to adopt SFAS No. 115 for reporting purposes even if not yet required by SFAS No. 115. The agencies have undertaken rulemakings to include unrealized gains and losses in capital. The OTS permitted early adoption for capital purposes in the interim as provided in the instructions to the June 1993 TFR.

Subsidiaries

The capital regulation generally defines a subsidiary as an ownership interest of 5% or more in an enterprise not occurring due to debts previously contracted (unless held for more than five years). Subsidiaries are either "includable" or "nonincludable."

Includable Subsidiaries

An includable subsidiary is one that is:

- Engaged solely (either directly or through ownership of a subsidiary) in activities permissible for a national bank;
  - — In case of a dispute over whether an investment is permissible for a national

bank, thrifts have the burden of providing OTS with evidence of permissibility of activities in law, regulations, or published OCC opinions.)

- Engaged solely as an agent in activities not permissible for a national bank;
- Engaged solely in mortgage banking activities;
- An insured depository institution or a holding company whose sole investment is an insured depository institution (acquired directly or indirectly by the thrift before May 1, 1989); or
- A subsidiary of any federal thrift existing as a federal thrift on August 9, 1989, that was either previously chartered by a state as a savings bank prior to October 15, 1982 or that acquired its principal assets from such a state savings bank.

Includable subsidiaries that are consolidated under GAAP are also consolidated with the parent for purposes of the capital standards.

Where a thrift has an ownership interest in an includable subsidiary not consolidated under GAAP, the consolidation is prorated for Tangible Assets. That is, the subsidiary's assets are multiplied by the thrift's percentage interest in the subsidiary and the resulting amount is consolidated (as a single asset, rather than line by line) with the parent thrift's assets.

<u>Nonincludable Subsidiaries</u>

Nonincludable subsidiaries are, generally, those engaged as principal in activities not permissible for national banks. HOLA section 5(t)(5) requires that investments in (and loans to) nonincludable subsidiaries made after April 12, 1989, must be excluded from Tangible Assets and Tangible Capital, unless grandfathered as discussed below.

For nonincludable subsidiaries engaged in impermissible activities prior to April 13, 1989, the Act provides a grandfathering transition period during which thrifts must exclude from Tangible Capital and Tangible Assets an increasing percentage of their investments in (and loans to) such subsidiaries each year. The regulation phases in an exclusion of such investments for purposes of determining Tangible Capital and Tangible Assets pursuant to §§ 567.5(a)(2)(v) and 567.9(c). By July 1994, all non-real estate investments in nonincludable subsidiaries must be excluded from Tangible Assets and Tangible Capital.

In October 1992, the President signed a law that permits OTS (on a case-by-case basis) to amend the phase-out schedule for investments by "eligible" savings associations in subsidiaries engaged in real estate activities if certain eligibility criteria are satisfied. OTS may extend the phase-out schedule for these investments until June 30, 1996.

On July 29, 1992, OTS published its "Miscellaneous Capital Rule" (57 FR 33432) simplifying the grandfathering treatment of investments in subsidiaries. This approach grandfathers the amount of a thrift's investment in its nonincludable subsidiary that existed on April 12, 1989, rather than the specific investments in such subsidiaries. As a result, the amount of the grandfathered investment being phased out under the transition schedule is the lesser of the current amount invested in a subsidiary(ies) or the amount invested on April 12, 1989.

During this transition period, the rule requires that the assets of nonincludable subsidiaries (where the amount of the investment has not been fully deducted) be consolidated on a prorated basis to the extent of the remaining investment. (Therefore, if a subsidiary were consolidated, consolidation must be reversed.) Thus, during the phase-in period, thrifts must multiply their ownership percentage in a nonincludable subsidiary by the subsidiary's assets and by that portion of its investment that is excluded under the transition schedule. For example, if a thrift must deduct 60% of its investment in an impermissible subsidiary and owns 40% of the subsidiary, the thrift deducts 60% of its 40% investment in the subsidiary. The thrift calculates 40% of the subsidiary's assets and includes 40% of the subsidiary's assets in its consolidated tangible assets. This treatment applies to all investments in nonincludable subsidiaries whether a thrift investment constitutes a minority or majority interest. Exceptions are discussed below.

If a previously includable subsidiary engages in an impermissible activity, then the subsidiary is deemed nonincludable and the entire thrift investment in the subsidiary is excluded from Tangible Capital and Tangible Assets.

If a nonincludable subsidiary increases impermissible activities begun prior to April 13, 1989, then the parent thrift's investment in the subsidiary is still grandfathered and phased out. If the nonincludable subsidiary increases assets, the assets must be prorated, provided the parent has not increased investment in the subsidiary. The parent thrift would be required to immediately deduct the amount of the new impermissible investment.

Subsidiary Depository Institutions

Generally, if a lower-tier depository institution is engaged solely in activities permissible for a national bank, the subsidiary is consolidated. Also, when OTS determines that the capital requirement for the parent thrift would be more stringent if the assets and liabilities of the parent and subsidiary were consolidated, the assets and liabilities of such lower-tier subsidiaries are consolidated with those of the parent thrift for purposes of determining compliance with capital standards, pursuant to HOLA sections 5(t)(5)(A), (C), and (E). Also, where such investments have been acquired before May 1, 1989, regardless of whether the lower-tier depository institution is engaged in activities not permissible for a national bank, the investment will not be excluded in determining capital compliance, pursuant to HOLA § 5(t)(5)(C)(ii). When a thrift, on or after May 1, 1989, acquires a depository institution, either directly or through a subsidiary (whose sole investment is a depository institution or institutions), the thrift's investment in the lower-tier depository institution (or intermediate subsidiary) will generally be excluded in determining capital compliance under all three capital standards.

Purchased Mortgage Servicing Rights

Under a new rule on the capital treatment of intangible assets, savings associations may include in intangible capital the same amount of qualifying purchased mortgage serving rights included in core capital. The amount of purchased mortgage servicing rights included in tangible capital and core capital is limited to 50% of core capital. The rule grandfathers inclusion of purchased mortgage servicing rights acquired prior to February 10, 1990. See the discussion of the treatment under the new rule of purchased mortgage servicing rights and other intangible assets set forth below in the core capital portion of this guidance.

Minority Interests in Equity Accounts of Fully Consolidated Subsidiaries

Minority interests in equity accounts of consolidated subsidiaries (where the minority interest is common stock or noncumulative perpetual preferred stock) are included in Tangible Capital unless OTS determines otherwise for a particular thrift. This could occur, for example, where the minority interest does not provide a cushion to absorb losses. In such a case, the minority interest may be included in Supplementary Capital instead of Tangible Capital.

Mutual Thrift Nonwithdrawable (Pledged) Deposit Accounts

Pledged deposits and nonwithdrawable accounts generally are funds of directors of mutual thrifts that are pledged to the thrift. If the claims of owners of such instruments are subordinated to the thrift's creditors including the FDIC, and they satisfy the same criteria as noncumulative perpetual preferred stock, then these deposits are included in Tangible Capital (for mutual thrifts only). To receive this treatment, there must be no maturity, no option to withdraw, and the obligation to pay interest may be suspended. Refer to §§ 567.5(a)(1)(iv) and 567.9(b)(3).

<u>Tangible Capital Calculation</u>

Tangible Capital can be calculated following TFR schedule CCR. The following guide provides more detail.

Total Equity Capital (consolidated GAAP) per TFR item CSC 81,

Less:

- Investments in and advances to nonincludable subsidiaries required to be deducted (subject to transition requirements);
- All intangible assets (e.g., goodwill, core deposit intangibles, PCCR), except for PMSR;
- Nonqualifying equity instruments such as cumulative preferred stock, collateralized preferred stock, and capital certificates;
- Nonqualifying and excess PMSR;
- Excess net deferred tax assets;

Plus:

- Qualifying PMSR;
- Qualifying minority interest in includable consolidated subsidiaries;
- Qualifying nonwithdrawable (pledged) deposit accounts of mutual associations;

Equals:

Tangible Capital.

<u>Tangible Assets</u>

Tangible Assets may be calculated following TFR schedule CCR. The following guide provides more detail.

Total Assets (consolidated GAAP) per TFR item CSC 61,

Less:

- All intangible assets (e.g., goodwill, core deposit intangibles, PCCR), except for PMSR;
- All assets of nonincludable GAAP-consolidated subsidiaries required to be deducted;
- Investments in nonincludable subsidiaries (including those subsidiaries that were deconsolidated);
- Investments in includable subsidiaries not GAAP consolidated;
- Nonqualifying and excess PMSR;
- Excess net deferred tax assets;

Plus:

- Pro rata share of assets of nonincludable unconsolidated subsidiaries allowed under transition provisions;
- Pro rata share of assets of includable unconsolidated subsidiaries;

Equals:

Tangible Assets.

The net difference between Total Equity Capital and Tangible Capital may not equal the net difference between Total Assets and Tangible Assets as in conventional tangible capital/tangible asset calculations because of the various adjustments shown above.

Leverage Ratio (Core Capital) Standard

This standard requires Core Capital of at least 3% of Adjusted Tangible Assets. Core Capital is Tangible Capital plus (1) Qualifying Supervisory Goodwill and (2) Other Qualifying Intangible Assets. Discussion of these items follows. Thrifts must generally have core capital equal to 4% of Adjusted Tangible Assets to be adequately capitalized for prompt corrective purposes.

Qualifying Supervisory Goodwill

Congress addressed the issue of goodwill in FIRREA. Section 18(n) of the FDIA [12 USC 1828(n)], added by § 221 of FIRREA, provides that no federal banking agency is to allow any depository institution to include any “unidentifiable intangible asset” (goodwill) acquired after April 12, 1989, in calculating capital except as permitted under HOLA § 5(t). This requires OTS to deduct such goodwill from capital.

Qualifying Supervisory Goodwill (QSG) includes goodwill resulting from prior regulatory accounting practices (FSLIC capital contributions) originated prior to April 13, 1989. FIRREA provides for a five-year phase-out and a maximum 20-year straight-line amortization of QSG that is included in core capital. QSG is defined to include goodwill created before April 13, 1989, resulting from acquisition, merger, consolidation, purchase of assets, or other business combinations with thrifts that failed their capital requirements or presented supervisory concerns. The regulation requires the immediate deduction of nonqualifying goodwill. Refer to §§ 567.1(h), (w), (ee), and 567.5(a).

Under FIRREA, the phase-out can only be used by "eligible" thrifts, i.e., those that are well-managed, in compliance with all applicable statutes, regulations, orders and supervisory agreements, and not involved in transactions that threaten the safety and soundness of the thrift.

OTS defined eligible thrifts in accordance with FIRREA and deemed thrifts with supervisory goodwill to be eligible thrifts until notified otherwise by the OTS Director.

Qualifying Intangible Assets

The new OTS rule governing the capital treatment of intangible assets became effective on March 4, 1994. This rule is consistent with the uniform approach to the capital treatment of intangibles set forth in rules adopted by all of the federal banking agencies. Under the rule, purchased mortgage servicing rights (PMSR) and purchased credit card relationships (PCCR) are defined as "qualifying intangible assets." They are included in core capital up to an aggregate of 50% of core capital provided that PCCR may not exceed a sublimit of 25% of core capital. PMSR and PCCR in excess of applicable limits, as well as core deposit intangibles (CDI) and other types of nonqualifying intangibles, would be deducted from both assets and capital in calculating tangible, core and total capital.

The new rule also (1) eliminates the prior three-part test for qualifying intangibles; (2) retains the 90% of book value and 100% of unamortized fair market value standards, but eliminates the 100% of original cost test; (3) grandfathers PMSR acquired before February 10, 1990, that were grandfathered under the FDIC rule (previously applicable to thrifts, 12 CFR § 325); and (4) grandfathers CDI, up to 25% of core capital, acquired or under firm contract on March 4, 1994. In calculating the amortized book value of PMSR and PCCR, associations must value these assets using a discount rate no lower than the discount rate embedded in the yield estimate for the assets when purchased.

PMSR held by a mortgage banking subsidiary are exempt from these limits under specific conditions, provided that thrift investment in and loans to the subsidiary are deducted from capital. Other important restrictions also apply.

Section 475 of the FDICIA authorizes the OTS to determine the amount of PMSR that may be included in calculating thrifts' tangible capital, leverage and risk-based capital requirements provided that such PMSR are valued at not more than 90% of their fair market value as determined quarterly. In accordance with Section 475 of FDICIA, the FDIC issued a rule in 1993 eliminating the applicability of its PMSR rule to savings associations.

<u>Adjusted Tangible Assets Calculations</u>

Adjusted Tangible Assets may be calculated following TFR schedule CCR:

Add:

- Tangible Assets;
- Other Qualifying Intangible Assets;

Less:

- Excess qualifying intangible assets and excess deferred tax assets;

Equals:

Adjusted Tangible Assets.

<u>Core Capital Calculation</u>

Core Capital can be calculated following TFR schedule CCR. The following guide provides more detail.

Add:

- Tangible Capital;
- QSG (subject to transition requirements);
- Other Qualifying Intangible Assets;

Less:

- Excess qualifying intangible assets and excess deferred tax assets;

Equals:

Core Capital.

The net difference between Tangible Assets and Adjusted Tangible Assets will not equal the net difference between Tangible Capital and Core Capital due to QSG being included in Core Capital and not in Adjusted Tangible Assets.

Risk-Based Capital Standard

The Risk-Based Capital Requirement is based in part on the credit risk presented by both its balance sheet assets and off-balance-sheet commitments and obligations. The asset base is determined from Adjusted Tangible Assets. Assets are assigned a credit risk weighting based upon the relative risk of the underlying collateral or obligor.

The risk weightings range from 0% (for assets backed by the unconditional full faith and credit of the United States), to 100% for many types of assets not qualifying for more favorable risk-weighting.

Off-balance-sheet commitments are converted to “credit equivalent” amounts by a conversion factor. The credit equivalent amounts are then risk weighted in accordance with the rules used for balance sheet assets.

The Total Risk-Weighted Assets net of Excess GVA is then multiplied by 8% to determine the minimum amount of capital required for those assets.

Certain assets, such as equity investments not permissible for national banks (after a limited phase-out period) are not included in the calculation of either the Risk-Based Capital Requirement or the Adjusted Total Capital. In other words, certain assets require dollar-for-dollar capital backing. These items are divided between Assets Required to be Deducted and Fully Capitalized Items.

The Risk-Based Capital Requirement is the total of the product of the capital percentage (8%) applied to Total Risk-Weighted Assets, plus Fully Capitalized Items. This requirement must be met with Adjusted Total Capital.

Calculation of Adjusted Total Capital

Adjusted Total Capital is Core Capital plus Allowable Supplementary Capital (limited to an amount equal to Core Capital) less the interest rate component and the amount of Assets Required to be Deducted. A discussion of major elements of this calculation follows.

Allowable Supplementary Capital

Supplementary Capital elements count toward a thrift’s Adjusted Total Capital up to a maximum of the thrift’s Core Capital.

Supplementary Capital components primarily include:

- Maturing capital instruments including mandatory convertible debt;
- Perpetual subordinated debt;
- Manditorily redeemable, cumulative perpetual, and FSLIC preferred stock;
- Mutual, net worth, and income capital certificates;
- Pledged deposits and nonwithdrawable accounts of stock and mutual thrifts (unless already included in a mutual’s Tangible Capital); and
- GVA (within limits).

A discussion of some of these components follows.

Maturing Capital Instruments

Maturing capital instruments for which an application had been approved by the FHLBB prior to December 5, 1984, and that were grandfathered under the prior capital regulation are also grandfathered under the current regulation and may be included in full in Supplementary Capital until the last year before maturity.

Section 567.5(b) includes two rules for the inclusion of maturing capital instruments in Supplementary Capital:

- Subordinated debt issuances (approved after December 4, 1984) that were in existence as of November 7, 1989, are subject to the provisions that were in effect on that date. See the amortization schedule from § 567.5(b)(3); and

- Subordinated debt issuances, or any other maturing capital instrument, issued after November 7, 1989, are covered by two options for thrifts - subject to the requirement that all such maturing capital instruments outstanding at any point in time must be treated the same way and such treatment documented.

  — Option 1 provides that, at the beginning of each of the last five years of the life of subordinated debt, the amount eligible to be included as Supplementary Capital is reduced by 20% of the original amount of the subordinated debt (net of redemptions).

  — Option 2 provides that only the aggregate amount of maturing capital instruments that mature in any one year during the seven years immediately prior to maturity that does not exceed 20% of the thrift's "capital" (defined only for this option as: Core Capital plus items permitted in Supplementary Capital without limit for GVA, maturing capital instruments, and total supplementary capital) is eligible to be included as Supplementary Capital.

  Capital instruments that mature in more than seven years are not subject to the 20% limit.

Once a thrift selects an option, however, that option applies to all maturing capital instruments subsequently issued by the thrift for as long as there is a balance outstanding of post-November 7, 1989 issuances. Only when the balance of post-November 7, 1989 maturing capital instruments (issued pursuant to the originally selected option) have been repaid, will the thrift be permitted to select the other option for new issuances.

Mandatory Convertible Subordinated Debt (MCD)

Mandatory convertible subordinated debt (MCD) that meets the criteria listed below is included in Supplementary Capital, subject to the provisions of §§ 567.5(b) and 563.81 of the regulations. OTS approval for including MCD as Supplementary Capital shall follow the same procedures that apply to the approval of subordinated debt in § 563.81. Approval shall be governed by these guidelines unless specifically waived by the OTS Deputy Director for Washington Operations. Both of the commonly recognized forms of MCD, equity contract notes and equity commitment notes, are includable in Supplementary Capital to the extent that they meet the following criteria:

- <u>Equity Contract Notes</u> require conversion into common or perpetual preferred stock by the holder on or before the maturity date of the MCD. Issuers of such MCD may retain an obligation to conduct a secondary offering of the equity securities on behalf of the holders of the MCD following maturity of the MCD. Equity contract notes are treated as permanent capital instruments under § 567.5(b)(1).

- <u>Equity Commitment Notes</u> are redeemable only with the proceeds of a sale of common stock or perpetual preferred stock. These MCD do not require the MCD holder to accept common or perpetual preferred stock on or before the MCD maturity. Equity commitment notes are treated as maturing capital instruments under § 567.5(b)(2) and (3).

Criteria applicable to both equity contract notes and equity commitment notes:

- The issuing thrift may redeem MCD prior to maturity only with the proceeds from the sale of common or perpetual preferred stock. The issuer may not repurchase or acquire its own MCD for resale or reissuance unless, following acquisition, the thrift will exceed the capital standards of Part 567.

  — Thrifts may issue MCD that provides for periodic changes in the interest rate or extensions of the maturity date and may allow holders the option to put the MCD to the thrift in connection with changes in interest rate or extensions of the maturity date. The thrift must, however, obtain further written approval from OTS (subject to the same procedural requirements that apply to the approval of subordinated debt instruments in § 563.81) if the extended maturity date or the new interest rate (or the index, auction, remarketing, or other procedure by which the interest rate is established) was not covered by the initial OTS approval of the MCD.

- Holders of the MCD may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.

- The right of payment of the MCD must be subordinate to all senior indebtedness of the issuing thrift and the claims of the FDIC.

- A thrift that intends to retire or redeem the MCD with the proceeds from the issuance of common or perpetual preferred stock generally must make such a dedication during the quarter in which the new common or perpetual preferred stock is issued. As a general rule, if the dedication is not made within the same quarter, then the stock may not be dedicated to retirement or redemption of the MCD.

  — Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the MCD. Documentation certified by an authorized agent of the issuing thrift showing the amount of common stock or preferred stock issued, the dates of issue, and the amounts of such issues dedicated to the retirement or redemption of the MCD will satisfy the dedication requirement.

  — The dedication procedure is necessary to ensure that the capital of the issuing thrift is not overstated. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the MCD notes, there is a corresponding reduction in the amount of outstanding MCD securities that may qualify as Supplementary Capital. De minimus amounts (in relation to Core Capital) of common or perpetual preferred stock issued under arrangements in which the amount of stock is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated before the thrift's fiscal year-end.

Additional criteria applicable only to equity contract MCD:

- The contract MCD must contain a contractual provision (or must be issued with a mandatory stock purchase contract) that requires the holder of the contract MCD to take the common or perpetual preferred stock of the issuing thrift in lieu of cash or other consideration in satisfaction of the claim for principal repayment. The obligation of the holder to take the common perpetual preferred stock of the issuing thrift may be waived if, and to the extent that, prior to the maturity date of the contract MCD, the issuing thrift sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the contract MCD. The dedication generally must be made during the quarter in which the new common or perpetual preferred stock is issued.

- A stock purchase contract may be separated from the contract MCD only if:
  - The holder of the stock purchase contract provides sufficient collateral, as determined by the OTS regional director, to the issuing thrift or to an independent trustee for the benefit of the issuing thrift to assure performance under the stock purchase contract; and
  - The stock purchase contract requires the purchase of common or perpetual preferred stock.

Additional criteria applicable only to equity commitment MCD:

- The commitment MCD indenture or agreement must contain the following provision:
  - The proceeds of the sale of common or perpetual preferred stock will be the sole source of repayment for the commitment MCD, and the issuing thrift must dedicate the proceeds for the purpose of repaying the commitment MCD. The dedication requirement will be satisfied by documentation certified by an authorized agent of the issuing thrift showing the amount of common or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of the commitment MCD.
- Any thrift failure to redeem the commitment MCD at or before maturity with the proceeds of an issue of common or perpetual preferred stock will be viewed as a breach of a regulatory commitment, may be grounds for the immediate issuance of a capital directive, and will be taken into consideration by OTS in acting on applications, where appropriate. OTS regional directors should be prepared to promptly seek and enforce a capital directive against any thrift that fails its capital standards because of a failure to issue capital instruments to redeem maturing equity commitment MCD or because of any other failure to meet capital standards where MCD instruments are involved.

Cumulative Perpetual Preferred Stock

Perpetual preferred stock is preferred stock with no fixed maturity date that cannot be redeemed at the option of the holder. Cumulative perpetual preferred stock instruments qualify for inclusion in Supplementary Capital with one exception: preferred stock issued by a thrift or subsidiary that is, in effect, collateralized by assets. Because this stock has a claim on assets that is senior to that of the insurance fund, such instruments do not qualify as capital.

Preferred stock with a dividend rate that is periodically reset in an auction type process (such as Dutch auction rate, remarketable rate, and money market preferred stock rate) to reflect the creditworthiness of the issuing thrift is included as Supplementary Capital (not Tangible Capital) regardless of whether dividends are cumulative or not.

Net Worth Certificates

Net worth certificates (NWCs) are instruments authorized by the Garn-St. Germain Depository Institutions Act of 1982 to provide capital assistance to thrifts that suffered losses and deterioration of regulatory capital because of economic conditions. Capital assistance was provided by the FSLIC through the purchase of NWCs issued by thrifts in exchange for promissory notes of the FSLIC. The certificates were included in the thrift’s regulatory capital, thus providing an additional cushion against regulatory insolvency. The FSLIC notes are recorded as assets on the thrift’s books and may be used as collateral for FHLB advances. As the thrift regains financial health, it should redeem the NWCs by returning the FSLIC promissory notes. NWCs are included in Supplementary Capital. NWCs are regulated by the FDIC pursuant to the FDIA at 12 USC 1823(i) and 12 CFR 390 of the FDIC rules and regulations. See § 545.19 of the regulations.

Nonwithdrawable (Pledged) Deposits

Nonwithdrawable (pledged) deposits generally belong to the owners or directors of the thrift and are pledged to the thrift. If the claims of owners of such instruments are subordinated to the thrift and the claims of the FDIC, these deposits are included in Supplementary Capital, provided they satisfy the same criteria as cumulative perpetual preferred stock and meet the requirements of § 561.42 (savings accounts) and are not included in Tangible or Core Capital. Refer to § 567.5(b)(1)(iii). Mutual thrifts may include pledged deposits in Tangible Capital, provided they meet the criteria of noncumulative perpetual preferred stock.

General Valuation Allowances

GVA do not include allowances held for specifically identified losses or earmarked for a specified asset. GVA, as a component of Supplementary Capital, is limited to 1.25% of risk-weighted assets (prior to subtracting Excess GVA). Refer to TFR schedule CCR items 65 and 530.

Supplementary Capital Calculation

Supplementary Capital can be calculated following TFR schedule CCR. The following guide provides more detail.

Add:

- Maturing capital instruments such as qualifying subordinated debt, redeemable preferred stock, mandatorily redeemable preferred stock, mandatory convertible commitment notes (subject to variable limits);
- Capital certificates (NWC, MCC, ICC, PICC);
- Nonwithdrawable (pledged) deposit accounts not included in Tangible Capital or Core Capital;
- Other equity instruments such as cumulative perpetual preferred stock and mandatory convertible equity contract notes;
- Minority interests in consolidated subsidiaries not qualifying as Tangible or Core Capital (meeting criteria); and
- GVA (subject to transition limits);

Equals:

Supplementary Capital.

Allowable Supplementary Capital

Allowable Supplementary Capital is Supplementary Capital limited to the amount of Core Capital.

Assets Required to be Deducted

Three classes of assets are either immediately excluded or phased out of Adjusted Total Capital: reciprocal holdings, nonsubsidiary equity investments (except those permissible for national banks), and portions of nonresidential construction and land loans.

Reciprocal Holdings

Reciprocal holdings of capital instruments issued by other depository institutions are fully excluded from Adjusted Total Capital (Risk-Based Capital). Reciprocal holdings are cross-holdings held under formal or informal agreements in which two or more depository institutions swap, exchange, or otherwise agree to hold each other's capital instruments. See definition at § 567.1(x) of the regulation.

Nonsubsidiary Equity Investments

Equity investments, except for equity investments permissible for national banks and investments in subsidiaries (which were dealt with in Tangible Capital and Core Capital), are deducted in calculations of Adjusted Total Capital. Thrifts are not required, however, to deduct these investments from Tangible Capital and Core Capital. They are phased out from calculations of Adjusted Total Capital over the same five-year transition period that is used for phasing out investments in nonincludable subsidiaries. By a final rule that became effective in April 1993, OTS modified its rules to place equity investments permissible for national banks in the 100% risk weight instead of requiring deduction.

Portions of Nonresidential Construction and Land Loans

Finally, in accordance with §567.5(c), the portions of nonresidential construction and land loans that are above an 80% loan-to-value ratio are excluded from Adjusted Total Capital subject to a phase-out. Loans with high loan-to-value ratios have been found to present particularly high levels of risk and should, therefore, be fully capitalized until better secured.

Interest-Rate-Risk Component

In August 1993, the OTS added an interest-rate-risk (IRR) component to the risk-based capital regulations. This component satisfies the requirements of Section 305 of FDICIA that the federal banking agencies ensure that their risk-based capital standards take adequate account of interest-rate risk.

The IRR component is a dollar amount that is deducted from total capital for the purpose of calculating an institution's risk-based capital requirement. The first date that the IRR component is to be deducted from total capital is July 1, 1994, based on data as of December 31, 1993. The IRR component is equal to one-half the difference between an institution's "measured exposure" and a "normal" level of exposure, as described below.

An institution's interest-rate-risk component is based on the sensitivity of its Net Portfolio Value (NPV) to changes in interest rates. The OTS calculates changes in an association's NPV based on financial data submitted on Schedule CMR of the Thrift Financial Report and using the OTS Net Portfolio Value Model described in Section 520.

An association's "Measured Interest-Rate Risk" (Measured IRR) is the change that occurs in its NPV as a result of a hypothetical 200 basis point increase or decrease in interest rates (whichever leads to the lower NPV) divided by the estimated economic value (present value) of its assets.[1] An institution with a "normal" level of interest-rate risk is defined as one whose Measured IRR is less than 2%, as estimated by the OTS Model. Only institutions whose Measured IRR exceeds 2% are required to maintain an IRR component.

[1] When the 3-month Treasury bond equivalent yield falls below 4 percent, the decrease (or downward shock) will be modified to be equal to one-half of such Treasury rate.

Net Portfolio Value Calculation

Present value of expected cash inflows from existing assets,

Less:

- Present value of expected cash outflows from existing liabilities,

Plus:

- Present value of net expected cash inflows from existing off-balance sheet contracts,

Equals:

Net Portfolio Value.

Calculation of the Change in NPV

Step 1: Calculate the savings association's "base case" NPV. (Use present value estimates based on the level of interest rates at the quarter-end date - referred to as the "base case" interest-rate scenario.)

Step 2: Determine the effect of an immediate parallel upward shift in the term structure of interest rates (i.e., the zero-coupon Treasury yield curve) on the association's NPV. This is done by adding 200 basis points to the quarter-end interest rates and recalculating the association's NPV. Such an immediate parallel shift in interest rates, in either the upward or downward direction, is referred to as an "interest-rate shock."

Step 3: Determine the effect of an immediate parallel downward shift in the term structure of interest-rates on the association's NPV. If the 3-month Treasury bill rate at quarter-end is 4% or above, the effect of a downward interest-rate shock on the association's NPV is estimated by subtracting 200 basis points from quarter-end interest rates and recalculating the association's

NPV. If the 3-month Treasury bill rate is below 4%, however, the downward rate shock is equal to one-half the value of the 3-month bill rate (e.g., 150 basis points if the 3-month bill rate is 3%.)

Step 4: Determine the decline in NPV by taking the lesser of the NPVs in the two (shocked) rate scenarios computed in Steps 2 and 3 and subtracting it from the base case NPV computed in Step 1.

IRR Capital Component Calculation

An institution's Measured IRR is equal to the change in its NPV divided by the estimated present value of its assets. That is,

$$\text{Measured IRR} = \frac{NPV_{Base} - NPV_{+200}}{\text{PV of Assets}_{Base}}$$

The "normal" level of IRR is defined as a decline in NPV equal to 2% or less of the estimated present value of an institution's assets due to a 200 basis point shock to interest rates.

The IRR component is the dollar amount that an institution is required to deduct from total capital in calculating its risk-based capital computation. The IRR component is calculated as one-half of the difference between its Measured IRR and 2%, multiplied by the present value of its assets:

$$\text{IRR Component} = \frac{(\text{Measured IRR} - .02)}{2} \times \text{PV of Assets}_{Base}$$

For example, suppose that the OTS produces the following estimates for an institution. Its base case NPV is \$10 million, and NPV rises to \$12 million in the -200 basis point scenario and falls to \$7 million in the +200 basis point scenario. The estimated present value of the institution's assets in the base case is \$100 million.

This institution's IRR component would be \$0.5 million, calculated as follows:

Step 1: Because it results in a lower NPV, the +200 basis point scenario is used to compute the IRR component.

Step 2: The institution's Measured IRR is 3%, calculated as follows:

$$\text{Measured IRR} = \frac{NPV_{Base} - NPV_{+200}}{\text{PV of Assets}_{Base}}$$

$$= \frac{(\$10 - \$7)}{\$100} = \frac{\$3}{\$100}$$

$$= 0.03 \text{ or } 3\%$$

Step 3: Because its Measured IRR exceeds the 2% normal level, this association is subject to an IRR component, calculated as follows:

$$\text{IRR Component} =$$

$$= \frac{(\text{Measured IRR} - .02)}{2} \times \text{PV of Assets}_{Base}$$

$$= \frac{(.03 - .02)}{2} \times \$100 = \frac{.01}{2} \times \$100$$

$$= \$.5 \text{ million}$$

Thus, the institution would have an IRR component of \$.5 million deducted from total capital. After the IRR component is deducted, the institution is required to have capital of at least 8% of risk-weighted assets.

Three Quarter "Lag"

The IRR component is computed on a quarterly basis. The capital requirement for interest-rate risk purposes has an effective "lag" of three quarters and, thus, the requirement goes into effect on the last day of the third quarter following the Schedule CMR on which the IRR component was calculated. For example, the interest-rate-risk component based on December 31, 1993 data becomes effective on September 30, 1994.

If an association is successful in reducing its IRR component prior to the effective date, then the component will be lowered to that amount. For example, if an institution's IRR component is \$.5 million based on December 31 Schedule CMR data, but declines to \$.4 million based on March 30, Schedule CMR data, and \$.3 million based on June 30, Schedule CMR data, the institution's IRR component effective on September 30 would be $.3 million, not $.5 million. In effect, the IRR component used to determine an institution's capital requirement September 30, 1994 is based on the lower of the December 1993, March 1994, or June 1994 IRR components.

Small, Highly Capitalized Institution Exemption

Small, highly capitalized institutions are not required to file Schedule CMR and are not subject to the IRR component.

To qualify for the filing exemption, an association must have less than $300 million in assets and a risk-based capital ratio in excess of 12%. The Director, or his designee, retains the discretion to require any otherwise qualifying institution to file Schedule CMR if there is a reason to be concerned about the institution. Any such institution would then be subject to the IRR component.

Adjusted Total Capital Calculation

Adjusted Total Capital may be calculated following the TFR schedule CCR.

Add:

- Core Capital;
- Allowable Supplementary Capital (limited to the amount of Core Capital);

Less:

- Assets Required to be Deducted:
  - — Reciprocal holdings of capital instruments;
  - — Nonsubsidiary equity investments (subject to a phase-out);
  - — Portion of nonresidential construction and land loans presently and originally above 80% loan to value (subject to a phase-out);
- IRR Component (beginning July 1, 1994);

Equals:

Adjusted Total Capital.

This figure is the capital available to meet the Risk-Based Capital Requirement.

Calculation of Risk-Based Capital Requirement

The risk-based capital requirement addresses both credit risk (risk-weighted assets) and interest-rate risk (interest-rate-risk component).

Risk-Weighted Assets

There are four risk weights applied to assets: 0%, 20%, 50%, and 100%. The risk weightings reflect the view that capital requirements should differentiate required capital based on institutions' exposure to credit risk. Section 5(t) of the HOLA also requires that the overall capital standards for thrifts be materially no less stringent than those for national banks.

The assets of a majority-owned and fully consolidated includable subsidiary are risk weighted in the same manner as assets of the parent. Investments in finance subsidiaries will be treated for capital standard purposes in the same manner as investments in other subsidiaries.

The asset items included in risk weighting are:

- Adjusted Tangible Assets;
- GVA (not net);
- Off-balance-sheet items (times a credit conversion factor);

Excluding:

- Nonsubsidiary equity investments that are impermissible for national banks (subject to a phase-out);
- Reciprocal holdings of capital instruments;

- Portions of nonresidential construction and land loans over 80% of collateral value (subject to a phase-out).

There is separate prescribed treatment for both balance sheet assets and off-balance-sheet items.

Risk Weight of Balance Sheet Assets

0% Risk-Weight Category

In general, this category includes only those assets with the least credit risk of thrift assets such as cash and obligations backed by the unconditional full faith and credit of the United States Government. This category includes balances at Federal Reserve Banks; the book value of paid-in Federal Reserve Bank stock; obligations of the Treasury, successor to the FSLIC, FDIC,; assets covered by the successor to the FSLIC; and GNMA obligations to the extent they are backed by the unconditional full faith and credit of the United States Government.

20% Risk-Weight Category

Generally, very high-credit-quality assets are in the 20% risk-weight category. This includes high-quality mortgage-backed securities; claims on, balances due from, and stock of Federal Home Loan Banks; items collateralized by cash; general obligations of state and local governments; and claims on domestic depository institutions.

The definition of high-quality mortgage-related securities includes those issued by, or fully guaranteed as to principal and interest by FNMA and FHLMC and other eligible mortgage-related securities under the Secondary Mortgage Market Enhancement Act (SMMEA) as defined in the Securities Exchange Act of 1934, codified as 15 USC 78c(a)(41). Also included are high-quality mortgage-backed bonds rated in the top two investment grade ratings (by a nationally recognized rating service), with other qualifications, that present minimal credit risk.

Obligations collateralized by securities issued or guaranteed by the U.S. Government or one of its agencies, such as the guaranteed portion of VA and FHA mortgages, are in the 20% risk-weight category.

50% Risk-Weight Category

Generally, high-credit-quality assets are given the 50% risk weighting. This includes qualifying single-family mortgage loans (excluding those over 90 days past due) and multifamily residential mortgage loans, securities backed by qualifying one- to four-family or multifamily mortgage loans, and most state and local revenue bonds. Qualifying one- to four-family residential mortgages include those on houses, condominiums, cooperative units, and manufactured homes. Boats, motor homes, and time-share properties are not considered residential property for the capital regulation, even if they are used as a primary residence. Mortgage loans on mixed-use properties that are primarily one- to four-family or multifamily residential properties are considered to be residential properties included in the 50% risk-weight category if they meet the qualifying criteria for one- to four-family or multifamily residential mortgage loans.

The definition of a qualifying one- to four-family mortgage loan means a first mortgage loan meeting the following criteria: (1) having a loan-to-value (LTV) ratio of 80% or less or that is insured to at least an 80% LTV ratio by private mortgage insurance from a qualifying insurer; (2) is performing; (3) is not more than 90 days past due; and (4) is prudently underwritten. Nonqualifying mortgage loans that are subsequently paid down to an LTV ratio of less than 80% (calculated using the value at loan origination) may become qualifying loans if they meet all other criteria for qualifying mortgages. Also loans to individuals for the construction of their own homes may be qualifying mortgage loans.

On March 18, 1994, a new OTS rule setting revised criteria for multifamily mortgage loans to qualify for inclusion in the 50% risk-weight category became effective. The rule implements § 618(b) of the Resolution Trust Corporation Refinancing, Restructuring and Improvement Act of 1991. The OTS rule, except for certain grandfathering and transition provisions discussed below, parallels rules adopted by the other Federal banking agencies. The qualifying criteria of the new rule consists of the statutory criteria specified in § 618 and two additional prudential standards imposed by the agencies.

The new rule defines qualifying multifamily mortgage loans to be those loans that (1) are secured by a first lien on a residence consisting of 5 or more dwelling units (no unit ceiling); (2) have a maturity of not less than seven years or more than 30 years; (3) have been performing according to their terms (not more than 30 days past due) for the prior year (at time initially included in 50% risk-weight category); (4) are performing and not more than 90 days past due; (5) were made in accordance with prudent underwriting standards; (6) have loan-to-value ratios on a continuing basis not exceeding 80% of appraised (or evaluated, as applicable) value (75% if variable rate loan); (7) have ratios on a continuing basis of annual net operating income generated by underlying properties (before payment of any debt service on the loan) to annual debt service on the loan no greater than 115% (120% for fixed-rate loan). In the case of cooperative or other not-for-profit housing projects, this debt coverage standard is considered to be satisfied if the property generates sufficient cash flow to provide comparable protection to the institution.

The new multifamily rule includes a grandfathering provision that keeps multifamily mortgage loans existing and included in the 50% risk-weight category on March 17, 1994, in the 50% risk-weight category if they continue to satisfy the criteria of the prior OTS rule. Under the prior rule, multifamily mortgage loans qualified for the 50% risk-weight category if they were secured by existing multifamily residential properties containing between 5 and 36 dwelling units, had an original loan-to-value ratio of 80% or less, and had 80% or higher occupancy rates for the preceding year.

The new rule places mortgage-related securities in the 50% risk-weight category if they are backed by multifamily mortgage loans that qualified for the 50% risk-weight category at the time of securitization. These multifamily mortgage-related securities may remain in the 50% risk-weight category, without tracking the continuing qualification of the underlying loans for the 50% risk-weight category, as long as the securities receive timely payment of principal and interest (i.e., not 30 days or more past due) in accordance with the terms of the securities. Furthermore, the OTS will continue to include high-quality multifamily MBS in the 20% risk-weight category.

Residential construction loans, also referred to as residential bridge loans, that meet the criteria of 12 CFR § 567.1(jj) are included in the 50% risk-weight category provided they meet the following criteria:

- The loan must be made in accordance with sound lending principles to a builder, who has paid the first 10% of direct costs of the project, for the construction of a pre-sold, one- to four-family residence.
- The home purchaser must: be an individual; intend to occupy the house; have made an earnest money deposit of at least 3% of the contract price held in escrow for benefit of the lending association; have entered into a firm purchase contract; and have obtained a firm commitment for a qualifying mortgage loan (as defined in 12 CFR § 567.1(u)).
- The loan must be secured by a first lien (except for mechanics' liens with priority under state law) on the lot and residence, must not exceed 80% of the sales price of the residence, and must be performing and not more than 90 days past due.
- The lending thrift must retain sufficient undisbursed loan funds throughout the construction period to ensure project completion.

<u>100% Risk-Weight Category</u>

This is the standard risk-weight category. All assets not assigned another risk weighting are placed in this category. This includes commercial loans, consumer loans, second mortgage loans, nondeducted equity investments, pro rata assets of unconsolidated includable subsidiaries, assets of nonincludable subsidiaries, and Qualifying Supervisory Goodwill (QSG). Additional examples include: home equity loans (assuming the first lien is held by the association), nonqualifying single-family and multifamily housing loans, gross construction loans, mortgage-backed securities not qualifying for a lower risk-weight category (strips and residuals), corporate debt securities, industrial revenue municipal bonds, and both excess mortgage servicing and PMSR (subject to FDIC limits and Tangible Assets requirements). [All one- to four-family residential mortgages and multifamily mortgages that are more than 90 days past due are placed in the 100% risk-weight category.]

When a thrift has a minority ownership interest in an includable subsidiary (one that engages in permissible activities and is not consolidated under GAAP), the assets of the subsidiary will, for capital purposes, be consolidated on a prorata basis, whereby the thrift will multiply its percentage of ownership in the subsidiary by the subsidiary's assets. That amount is placed in the 100% risk-weight category.

A thrift's investments in or extensions of credit to a nonincludable subsidiary must eventually be deducted from the thrift assets for purposes of determining compliance with the capital standards. If the subsidiaries were engaged in impermissible activities as of April 12, 1989, however, FIRREA provides a schedule for phasing out the inclusion of the pre-April 13, 1989, as discussed above. During this transitional period, § 567.6(a) places the reciprocal percentage of the subsidiary's assets in the 100% risk-weight category in calculating the parent thrift's risk-based capital requirement. For example, if 60% of the parent association's investment must be deducted under the transition schedule, place 40% of the subsidiary's assets in the 100% risk-weight category.

Equity investments not permissible for national banks are to be phased out from capital calculations over a five-year period. (Same phase-out as for non-real estate related, nonincludable subsidiaries.) During this transition period, the capital rule requires deduction of a portion of the equity investments and places the remaining assets in the 100% risk-weight category. Under a rule finalized in 1993, equity investments permissible for national banks are placed in 100% risk weight and are not subject to deduction requirement.

<u>200% Risk-Weight Category</u>

OTS adopted a final rule at the end of 1992 that eliminated the 200% risk weight. Assets that would have been in the 200% category are now in the 100% category.

Appendix A to this Handbook Section lists assets by risk-weight category.

Investments Provided Special Treatment

<u>Collateralized Mortgage Obligations (CMOs)</u>

CMOs are mortgage-related securities collateralized by mortgages or mortgage-related securities. CMOs are multi-class securities where each class (or tranche) is a type of bond. Interest-rate, prepayment rate, and principal loss risk vary significantly for each tranche. The risk weights for CMO tranches range from 20% to 100% depending on the credit risk and interest-rate risk of each tranche. The new interest-rate-risk rule will change the risk-weighting on certain "high risk" mortgage derivatives on July 1, 1994. The Thrift Bulletin 38 series contains specific information for assigning risk weights to each tranche.

<u>Ownership in Investment Companies</u>

Investments in investment companies, such as mutual funds, are assigned to the risk-weight category applicable to the riskiest asset held in the investment company portfolio. If the investment company holds assets that a thrift would have to deduct from capital, then the thrift must deduct its investment from capital. On a case-by-case basis, the OTS may allow thrifts to risk weight these investments on a pro rata basis based on the percentage breakdown of the portfolio by risk weight.

Credit Conversion Factors for Off-Balance-Sheet Items

Risk weights for off-balance-sheet items are determined by a two-step process. The face amount of the item is multiplied by a credit conversion factor to get the balance sheet credit equivalent amount that is then risk weighted depending on the collateral, the obligor, or type of asset. The credit conversion and risk weighting of off-balance-sheet obligations such as recourse servicing can require capital in excess of the book value of the obligation. There are four credit conversion factor groups discussed in greater detail in § 567.6(a)(2) of the regulations and the instructions for the TFR. The credit conversion factor groups are 100%, 50%, 20%, and 0%.

<u>100% Credit Conversion Factor Group</u>

This group includes:

- direct credit substitutes, such as financial guarantee type standby letters of credit and LIP used as a direct credit substitute;
- risk participations in bankers' acceptances and direct credit substitutes;
- assets sold under an agreement to repurchase and assets sold with recourse;
- forward agreements with a certain drawdown; and
- indemnification of customers whose securities were loaned by the thrift as agent.

The OTS capital rule treats an asset sale with recourse, if not included on the balance sheet, as an off-balance-sheet item. Capital is required against the amount of assets sold, except where the contractual maximum recourse liability is less than the regular capital requirement. Subordinated portions of senior/subordinated loan structures or securities are treated consistently by charging capital against both the senior and subordinated portions limited by a dollar-for-dollar capital charge on the subordinated interest held.

Under the OTS capital rule, asset sales with only standard representations and warranties are not considered sales with recourse. Standard representations and warranties generally relate to representations that are or should be within a thrift's knowledge and control at the time it originates a loan. For example, representing that the securing property exists, that a security interest has been perfected, that there is clear title and that the borrower has income and is not a minor are standard representations and warranties. A representation or warranty that there has been no fraud in the transaction is also considered a standard representation and warranty because the originating institution is generally closer to and has more ability to protect against fraud than a purchaser of a loan or mortgage-related security in the secondary mortgage market. On the other hand, commitments to cover losses or replace loans if they become delinquent within a set period (e.g., four months), or if they ever lose value because of environmental problems, do constitute recourse and are not considered standard representations and warranties no matter how common such provisions may be.

The OTS and the other Federal banking agencies are developing a proposed rule and an advanced notice of proposed rulemaking dealing with recourse and direct credit substitutes. OTS will request public comment on all aspects of the rulemaking when it is published in the Federal Register.

On the TFR, Fully Capitalized Items are a specific dollar amount capital charge equal to the maximum contractual liability under a recourse obligation or direct credit substitute if that amount is less than the capital charge against all assets sold. This amount is added to the capital requirement on risk-weighted assets.

<u>50% Credit Conversion Factor Group</u>

This group includes:

- transaction-related contingencies such as performance bonds and performance-based standby letters of credit related to a transaction;
- unused portions of commitments, such as home equity lines that are not unconditionally cancelable, with an original maturity exceeding one year (with exceptions in the 0% group);
- revolving underwriting facilities where a thrift customer may issue obligations that the thrift must either purchase or fund; and

- LIP commitments with original maturity over one year.

<u>20% Credit Conversion Factor Group</u>

This group is limited to trade-related contingencies collateralized by goods such as commercial letters of credit.

<u>0% Credit Conversion Factor Group</u>

This group includes:

- unused commitments (including LIP) with an original maturity of one year or less;
- unused commitments (including LIP) with an original maturity of more than one year if unconditionally cancelable and the thrift makes a separate credit decision before honoring each draw; and
- unused amounts in unconditionally cancelable retail credit card lines.

Loans in Process

Under GAAP, construction loans are booked gross, with undisbursed amounts booked as a contra asset - Loans in Process of Disbursement (LIP). LIP and other undisbursed loan commitments are always ignored (which is netted to the gross commitment) in the leverage ratio and tangible capital calculations.

LIP is also netted to the commitment balance and the resulting net loan amount outstanding is risk weighted in calculating the risk-based capital requirement.

Construction loan LIP, as well as all undisbursed loan commitments are off-balance-sheet items and are addressed using the conversion factor of 0% or 50% (according to Part 567 and TFR instructions) in determining the risk-based capital requirement.

There are two exceptions for this treatment of LIP:

- When interest is charged on the full amount of the construction loan commitment (interest is charged on LIP), the gross amount of the commitment is risk weighted as if the entire balance was disbursed and outstanding. (LIP is treated as an outstanding balance.)
- When LIP is used as a direct credit substitute, it receives a 100% credit conversion factor for risk weighting.

Interest-Rate and Exchange-Rate Contracts

The rule defines interest-rate contracts as: single currency interest-rate swaps; basis swaps; forward rate agreements; interest-rate options purchased; forward deposits accepted; and any other instrument that, in the opinion of OTS, may give rise to similar risks, including when-issued securities.

As a general rule, interest-rate contracts and exchange rate contracts cannot be netted. Each interest-rate contract is valued separately. An association may, however, net multiple contracts with a single counterparty only if those contracts are subject to novation. The term “novation” means a bilateral contract between two counterparties under which any obligation to each other is automatically amalgamated, legally substituting one single net amount for the previous gross obligations. OTS is participating in a joint rulemaking with the other federal banking agencies to permit netting by other bilateral netting methods resulting in net obligations recognized under all relevant bankruptcy and other laws of all jurisdictions and legal authorities involved.

The credit equivalent amount of interest-rate and exchange-rate contracts is the sum of current credit exposure and potential credit exposure. The risk weight is based on the obligors, guarantors, and collateral. The regulation at § 567.6(a)(2)(v) provides detailed definitions and the TFR instructions provide detailed instructions. Generally, the capital requirement is the sum of: (1) replacement value of the contract (adjusted for netting by novation) plus (2) a charge for potential credit exposure calculated by multiplying notational principal amount of the contract by a credit conversion factor (e.g., 0% for interest-rate contracts of one year or less and 0.5% for interest-rate contracts with remaining maturity of greater than one year).

The credit equivalent of interest-rate contracts of banks, thrifts, Federal Reserve Banks, and Federal Home Loan Banks are assigned the 20% risk weight. The maximum risk weight assigned to the credit equivalent amount of an interest-rate contract is 50%.

Excess General Loan and Lease Valuation Allowances

Excess GVA are netted with risk-weighted assets in computing Total Assets. The amount of excess GVA is derived from the total consolidated GVA by netting the amount included in Supplementary Capital. This figure must be determined after the determination of GVA included in Supplementary Capital.

Fully Capitalized Items

This item represents the dollar amount of recourse liability retained or assumed by a thrift for assets sold with recourse when the maximum contractual recourse liability (limited recourse amount) is less than the normal capital charge. The capital charge (fully capitalized items) equals the maximum contractual recourse liability. The underlying assets are not converted to an on-balance sheet equivalent amount or included in risk-weighted assets. For example, with asset sales under a 1% recourse clause, the amount of recourse liability is usually less than the normal capital charge and, therefore, 1% of the assets sold would be reported as a Fully Capitalized Item.

<u>Risk-Based Capital Requirement Calculation</u>

The Risk-Based Capital Requirement may be calculated following the TFR schedule CCR. The following guide provides more detail.

Add:

- Adjusted Tangible Assets;
- GVA (not net);
- Off-balance-sheet items (times a conversion factor);

Less:

- Assets required to be deducted.
- The above assets and items should be sorted by risk-weight category and the risk-weight percentages applied. Then,

Add:

- 20% risk-weight total;
- 50% risk-weight total;
- 100% risk-weight total;

Equals:

Subtotal of risk-weighted assets.

— GVA permitted in Supplementary Capital is limited to 1.5% of this subtotal.

Less:

- Excess GVA;

Equals:

Total Risk-Weighted Assets.

Multiply by:

- Risk-based capital percent (8%);

Equals:

Total Risk-Weighted Assets times risk-based capital percent.

Add:

- Fully Capitalized Items (not included in Assets Required to be Deducted);
- Interest-Rate-Risk Component (beginning July 1994);

Equals:

Risk-Based Capital Requirement.

Transition Provisions of Part 567

The OTS capital rule contains a number of transition provisions that are required by statute or regulation. The transition provisions applicable to investments in impermissible subsidiaries, equity investments impermissible for national banks, qualifying supervisory goodwill, general loan and lease valuation allowances, and maturing capital instruments are set forth below.

Investments in Impermissible Subsidiaries and Nonsubsidiary Equity Investments

FIRREA provides that, in general, all of a thrift's investments in and extensions of credit to any subsidiary, as defined in § 567.1(dd), engaged as a principal in activities that are impermissible for a national bank must be excluded from Tangible Capital and Tangible Assets.

Notwithstanding this provision, the statute provides that, if a thrift's subsidiary was engaged, as of April 12, 1989, in investments that are impermissible, the thrift is allowed to phase in the exclusion requirement for pre-April 13, 1989 investments in the subsidiary. For impermissible subsidiaries engaged in real estate-related transactions, OTS is permitted by statute to extend this transition to June 1996.

Section 567.5(c)(3) provides a transition for the exclusion of nonsubsidiary equity investments (other than those permissible for a national bank) and the portion of nonresidential construction and land loans that remain over 80% of value (without consideration of investment date). This transition is the same as that applicable to impermissible subsidiaries other than those engaged in real estate-related transactions. These assets are excluded from Adjusted Total Capital and Total Risk-Weighted Assets.

The following percentages are required to be excluded:

July 1, 1993 - June 30, 1994	60%
Thereafter	100%

Qualifying Supervisory Goodwill

Section 5(t)(3) of HOLA allows for the inclusion of certain Qualifying Supervisory Goodwill (QSG) in Core Capital. Under the provisions of the statute, eligible thrifts may include QSG as defined in § 567.1(w) up to the applicable percentage of Adjusted Tangible Assets (not including QSG) as follows:

January 1, 1994 - December 31, 1994	0.375%
Thereafter	0%

General Loan and Lease Valuation Allowances (GVA)

Section 567.5(b)(4) of the regulation permits GVA, established pursuant to §§ 563.160 and 563.233, to be included in Supplementary Capital up to 1.25% of risk-weighted assets (prior to netting Excess GVA).

Maturing Capital Instruments

For all maturing capital instruments approved after December 4, 1984, and issued on or before November 7, 1989, the following amortization schedule applies:

Percent included in Supplementary Capital:

Years to maturity greater than or equal to 7	100%
Less than 7 but greater than or equal to 6	86%
Less than 6 but greater than or equal to 5	71%
Less than 5 but greater than or equal to 4	57%
Less than 4 but greater than or equal to 3	43%
Less than 3 but greater than or equal to 2	29%
Less than 2 but greater than or equal to 1	14%
Less than 1	0%

The regulation also gives associations with maturing capital instruments issued on or before November 7, 1989, the option to follow either of the alternative approaches for maturing capital instruments issued after November 7, 1989.

Individual Minimum Capital Requirement

Compliance with the minimum capital requirement alone cannot ensure adequate levels of capital. OTS' examination staff conducts an analysis of each association's capital adequacy and may require a thrift to raise additional capital by requiring additional capital in the examination report, imposing a prompt corrective action directive, or imposing an individual minimum capital requirement. HOLA Section (5)(s) codified at 12 USC 1464(s) gives OTS authority on a case-by-case basis to establish a capital requirement for an association that is higher or lower than the minimum capital standard.

One way OTS may raise an association's capital requirement is by imposing an individual minimum capital requirement (IMCR) per § 567.3. Generally, IMCRs are appropriate for thrifts that have above normal levels of risk. The minimum capital requirements set forth at § 567.2 apply to intended sound, well-managed thrifts without significant risks or problems.

IMCRs, however, should not be used to address credit quality problems that are more properly dealt with by valuation allowances or to address other supervisory problems that should be addressed by more direct supervisory actions.

The following are considered appropriate reasons for the establishment of an IMCR. A thrift

- is receiving special supervisory attention.
- has or is expected to incur losses that will result in capital inadequacy.
- has a high degree of exposure to risk, such as interest-rate, prepayment, or credit risk, or a high proportion of off-balance-sheet risk that is not adequately dealt with under the capital rule.
- has poor liquidity or cash flow.
- is experiencing growth, either internally generated or through acquisitions, at such a rate that supervisory problems are presented.
- is adversely affected by the activities or condition of its holding company, affiliates, subsidiaries, or other institutions or persons with which it has significant business relationships (including concentrations of credit).
- has a portfolio disclosing weak credit quality or significant likelihood of financial loss, or has a high percentage of nonperforming loans or loans on which borrowers fail to comply with repayment terms.
- has inadequate underwriting policies, standards, or procedures for its loans and investments.
- has (1) management deficiencies, (2) a record of noncompliance with supervisory actions or agreements, or (3) a record of operational losses that exceeds the average of other similarly situated thrifts.
- with overvalued excess servicing using below-market discount rates for valuation.

Procedures have been established in 12 CFR § 567.3 for setting an IMCR. The regional director must notify the thrift and any appropriate state supervisor of a proposed IMCR. This notice must provide the schedule for compliance with the new requirement and the reasons for determining that the higher IMCR is necessary or appropriate. A copy of the notifying letter shall be sent to the OTS Deputy Director for Regional Operations in Washington along with supporting documentation.

Any response from the thrift or state supervisor must be made in writing and received by the regional director within 30 days after the date on which the notification was received. The response shall include any information that the thrift wants the regional director to consider in deciding whether to establish or amend an IMCR, what the IMCR should be, and, if applicable, what compliance schedule is appropriate. The regional director may extend or shorten the response period for due cause. Failure to respond constitutes a waiver of objections. A copy of any response shall be sent to the OTS Deputy Director for Regional Operations in Washington.

Based on the responses received and any other relevant information, the regional director shall decide whether the IMCR should be imposed. The regional director's decision shall address comments received within the response period and shall state the level of capital required, the schedule for compliance with the requirement, and any specific remedial action the thrift could take to eliminate the need for continued applicability of the IMCR. The regional director shall send a copy of the recommended final determination (within 15 days) to the Deputy Director for Regional Operations, who must approve, disapprove, or modify the regional director's recommendation before the decision becomes effective and is communicated to the thrift and state supervisor (if applicable). If needed, the Deputy Director for Regional Operations may increase the response period by an additional 15 days.

The regional director shall provide the thrift with a written decision on the IMCR, addressing the substantive comments made by the thrift in setting forth the basis for the decision. The IMCR becomes effective and binding upon receipt of the decision by the thrift. The decision represents a final agency action. Failure to satisfy an IMCR or meet any required incremental additions to capital under a schedule for compliance with such an IMCR shall constitute a legal basis for issuing a capital directive pursuant to § 567.4 of the regulations. See the IMCR regulation, § 567.3, for the procedure to modify this schedule if necessary.

Consequences of Capital Standard Failure

The text below discusses two overlapping supervisory regimens for dealing with undercapitalized savings associations. FIRREA established a capital plan and capital directive process under the HOLA for dealing with undercapitalized savings associations. Then, in 1991, FDICIA established the PCA regimen for depository institutions and required the OTS, FRB, OCC, and FDIC to adopt implementing regulations.

HOLA Capital Plans

HOLA §§ (ACA) 5(s) provides that the OTS Director may treat failure to maintain required capital as an unsafe and unsound practice. Furthermore, under § 5(t)(6) and (t)(7) of the HOLA any thrift not in compliance with the capital regulations must submit a plan to the Director detailing its efforts to correct its capital situation. Any material failure to comply with a plan constitutes an unsafe or unsound practice.

Asset growth is prohibited except as provided under limited circumstances where any increase in assets is accompanied by an increase in Tangible Capital, Core Capital, and Adjusted Total Capital (Risk-Based Capital and satisfaction of other requirements set forth in § 5(t) [12 USC 1464] of HOLA).

OTS has provided guidance to thrifts on the capital plan and capital directives process under FIRREA. (See the Thrift Bulletin 36 series and 12 CFR § 567.10(b) and (d) for further information.)

HOLA Capital Directives

HOLA §§ 5(s) and 5(t) grant OTS authority to issue a capital directive when a thrift fails to comply with the minimum capital requirements under § 567.2, an IMCR under § 567.3, or any capital requirement established on a case-by-case basis.

Directives and capital plans are enforceable under HOLA § 5(d), codified at 12 USC § 1464(d), or FDIA § 8 (12 USC § 1818) in the same manner and to the same extent as an effective and outstanding cease-and-desist order issued by OTS or FDIC.

<u>HOLA Capital Directives Policy</u>

Capital directives must be issued to all institutions that fail to meet one or more of their minimum capital requirements, unless the regional director has granted a capital exemption in accordance with the statutory criteria [HOLA § 5(t)(7)]. To grant an exemption, the regional director must conclude that the association meets the statutory standards permitting approval of the exemption and must approve the institution's capital plan. The relevant minimum capital requirements include any case-by-case requirements (e.g., by individual minimum capital requirement, written agreement, or application condition), as well as the statutory and regulatory minimum requirements.

In general, a capital directive will be issued, where:

- management is marginal or poor;
- there is evidence of objectionable insider dealings or abuse;
- the capital plan has less than a high probability of success;
- the capital shortfall is large relative to the institution's current earnings capacity;
- the institution has failed to comply with a prior capital plan in a significant fashion or is not in compliance with any outstanding remedial program (e.g., supervisory agreement, consent decree, or capital directive);
- the institution is experiencing persistent operating losses; or
- the association has significant credit risk or interest-rate-risk problems.

When the OTS decides to initiate a capital directive, it provides notice to the savings association, considers responses received, and makes a final decision to issue a directive. Broad authority to issue capital directives has been delegated to the regional directors and other regional officials. The regional directors have authority to issue capital directives for those associations with assets of $5 billion or less, unless the case raises a significant issue of law or policy. OTS intends to actively enforce directives in the event of noncompliance.

Section 337.6 of the FDIC rules and regulations prohibits undercapitalized thrifts from accepting or renewing brokered deposits. The FDIC may grant a waiver to this prohibition. The prohibition does not apply to conservatorships or receiverships of the FDIC or RTC.

Prompt Corrective Action

Congress imposed the prompt corrective action(PCA) framework to ensure prompt supervisory action in dealing with undercapitalized institutions. The PCA provisions of FDICIA are contained in Section 38 of the Federal Deposit Insurance Act ("Section 38").

Notification Process

The OTS PCA rule sets forth the process by which institutions will be notified or deemed notified of their PCA categories. An institution is notified or deemed notified of its capital level and capital category as of the date of the earlier that:

- A Thrift Financial Report (TFR) is required to be filed with OTS;
- A final report of examination (ROE) is delivered to the savings association; or
- Written notice is provided by OTS to the institution of its PCA category or that its category has been changed in accordance with § 565.4(c).

A savings association also shall notify OTS in writing that an adjustment to its PCA category may have occurred no later than 15 calendar days following the date that any material event has occurred that would cause the association to be placed in a lower PCA category than its category based on its most recent TFR or ROE. After receiving such a notice, OTS shall determine whether to change the association's PCA category and notify the association of that determination.

Calculation of Prompt Corrective Action Categories

Associations, with the exceptions noted below, are placed into one of the following PCA categories based on their capital levels computed using the TFR formulas shown in Appendix B: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Different supervisory and enforcement provisions apply to each PCA category (see the following discussion on "PCA Categories: Restrictions and Requirements").

Institutions that satisfy the numerical capital requirements for the well-capitalized category are placed in the adequately capitalized category if they are subject to capital directives, capital plans, or cease and desist orders requiring them to meet and maintain a specific capital level for any capital measure.

Section 38 also provides for taking more stringent action than normally accorded to institutions with their capital levels based on non-capital considerations, if the association is in an unsafe or unsound condition or engaged in an unsafe or unsound practice. Under these provisions OTS may place associations whose capital qualifies them for the well-capitalized category in the adequately capitalized category. OTS may also impose restrictions normally applicable to the next lower category on associations in the adequately capitalized category or undercapitalized category.

Timeframe for Filing Capital Restoration Plan

In general, a savings association not operating under a grandfathered capital plan shall file a capital restoration plan with its regional office within 45 days of the date the savings association is notified or deemed notified that it is in one of the three undercapitalized categories: undercapitalized, significantly undercapitalized, and critically undercapitalized (undercapitalized category(ies)). OTS, however, may set a different deadline for an association to submit its capital plan. If an institution is operating under an approved nongrandfathered capital plan, the OTS will provide the institution with guidance on additional submissions and modifications necessary to comply with the requirements of Section 38.

Capital Restoration Plans

Any association in one of the three undercapitalized categories must submit a capital restoration plan, unless it is operating under a grandfathered capital plan. The OTS may not accept a PCA capital restoration plan unless the plan meets certain statutory criteria.

Approval Standards: Guarantee of Controlling Companies

Section 38 prohibits OTS from accepting a capital restoration plan unless each company that directly or indirectly controls a savings association (1) guarantees that the association will comply with its plan until it is adequately capitalized on average during each of four consecutive quarters, and (2) provides appropriate assurances of performance. OTS has developed a standard guarantee that companies controlling savings associations must submit. The guarantee must be executed by a majority of each company's board of directors or a duly authorized representative.

PCA Categories: Restrictions and Requirements

Section 38 prescribes the requirements and restrictions applicable to each prompt corrective action category. The restrictions applicable to each PCA category are listed in Appendix C and are described in the subsections of Section 38 as follows:

- subsection (d) - mandatory prohibition against any association making capital distributions or payment of management fees if it will result in an association being undercapitalized;
- subsection (e) - mandatory restrictions applicable to undercapitalized associations;
- subsection (f) - mandatory and discretionary provisions applying to significantly undercapitalized associations and certain adequately capitalized associations (e.g., adequately capitalized associations failing to submit or comply with capital restoration plans), some of which the statute presumes OTS will impose;
- subsection (g) - more stringent treatment of associations in undercapitalized categories on other supervisory grounds;
- subsection (h) - restrictions and actions applicable to critically undercapitalized associations (including mandatory placement in conservatorship or receivership unless excepted under specific criteria); and

- subsection (i) - activity restrictions imposed by the FDIC on critically undercapitalized institutions.

PCA: Supplement to Existing Authority

Section 38 and the OTS rules on PCA explicitly supplement, and do not replace, the existing supervisory and enforcement authority of the OTS to deal with capital deficiencies and other supervisory problems. Accordingly, OTS retains all supervisory and enforcement authority under the HOLA and FDIA to deal with associations, including those associations operating under grandfathered capital plans. Moreover, any restrictions or limitations applicable to a savings association under an existing capital plan, or pursuant to other supervisory or enforcement action, remain in effect.

<u>Grandfathered Capital Plans</u>

A savings association operating under a capital plan approved before December 19, 1991, is exempt from most PCA restrictions until July 1, 1994, if that capital plan remains in effect and the association remains in compliance with the plan. Such an association is not required to submit a capital restoration plan until that date. OTS, however, retains its authority under § 5(t) of the HOLA over these capital plans. This includes the authority to terminate such a plan and its grandfathered status when the association fails to comply with the plan, thereby making the association subject to the same PCA restrictions and requirements as other undercapitalized associations.

REFERENCES

United States Code (12 USC)

§ 1464(b)(3)(A)	Borrowing Limited By Capital
§ 1464(d)	Regulatory Authority
§ 1464(s)	Minimum Capital Requirements
§ 1464(t)	Capital Standards
§ 1467a note	Savings Provisions
§ 1818	Termination of Insurance
§ 1823(c)	Assistance to Depository Institutions
§ 1823(i)	Net Worth Certificates
§ 1823(k)	Emergency Acquisitions
§ 1831e	Activities of Savings Associations
§ 1831f	Brokered Deposits

Code of Federal Regulations (12 CFR)

Chapter I: Comptroller of the Currency
Part 3: Minimum Capital

§ 3.2	Definitions
§ 3.100	Appendix A, Section 2

Chapter III: Federal Deposit Insurance Corporation

§ 325	Capital Maintenance
§ 337.6	Brokered Deposits
§ 387.10	Liquidation Account
§ 390	Net Worth Certificates
§ 391	Voluntary Assisted Merger Program

Chapter V: Office of Thrift Supervision
Subchapter C: Regulations For Federal Savings Associations

§ 544.1	Federal Mutual Charter
§ 544.2(b)(4)	Mutual Capital Certificates
§ 545.14(c)	Distributions on Share Accounts
§ 545.18	Issuance of Mutual Capital Certificates
§ 545.19	Issuance of Net Worth Certificates
§ 545.73	Investments in Inter-American S&L Bank
§ 545.74	Service Corporations
§ 545.77	Investment in Real Estate for Premises
§ 556.5	Branching by Federal Savings Associations

Subchapter D: Regulations Applicable to All Savings Associations

§ 563.10	Earnings-Based Accounts

§ 563.22	Mergers; Consolidations
§ 563.37	Operation of Service Corporations
§ 563.47	Pension Plans
§ 563.74	Mutual Capital Certificates
§ 563.81	Issuance of Subordinated Debt and Manditorily Redeemable Preferred Stock
§ 563.84(e)	Transfer and Repurchase of Government Securities Limited by Capital
§ 563.93	Loans to One Borrower Limited by Capital
§ 563.95	Investment in State Housing Corps
§ 563.96	Certain Investments Limited by Capital
§ 563.131	Liability Growth
§ 563.132(c)	Securities Issued through a Subsidiary included in Computation of Capital Requirement
§ 563.134	Capital Distributions
§ 563.173	Forward Commitments
§ 563.174	Futures Transactions
§ 563.175	Financial Options Transactions
§ 563.176	Interest Rate Risk Management
Part 563b.3	Conversions
Part 565	Prompt Corrective Action
Part 567	Capital
§ 571.21	Separate Corporate Existence of a Service Corporation

Chapter IX: Federal Housing Finance Board
Subchapter B: Federal Home Loan Bank System

§ 940.1(d)	FHLB Credit Consideration

Office of Thrift Supervision Bulletins

RB 18	Enforcement Series
RB 19	Subordinated Debt in Capital
RB 26	Capital Requirements-Recourse Agreements
TB 36a	Capital Plans, Exemptions, Exceptions
TB 36-1	Capital Plans
TB 36-2d	Interest Rates Used in Financial Projections Contained in Capital Plans
TB 38	Capital Requirements on CMOs
TB 38-1	Core Deposit Intangibles
TB 38-2a	Forbearances
Transmittal 004	Treatment of LIP in Capital

Capital Adequacy
Program

Examination Objectives

To determine the adequacy and composition of the thrift's present and planned level of capitalization, considering its unique risk characteristics, overall condition, and planned direction.

To determine the effectiveness of management and the board of directors in actively monitoring, maintaining, and planning for capital adequacy.

To determine if capital-related policies and procedures are adequate and being adhered to by thrift personnel.

To determine the adequacy of audit and accounting practices and procedures, including the system of internal controls, as they relate to the propriety of capital accounts.

To determine compliance with laws, rulings, regulations, and specific agreements with the OTS, FDIC, or state authorities.

To ascertain the need for, or to initiate, corrective action (including acting under prompt corrective action provisions) when policies, practices, procedures, or internal controls are deficient or when violations of laws, rulings, directives, or regulations have been noted.

Examination Procedures

Level I

Wkp. Ref.

1. Obtain and review copies of pertinent correspondence between the thrift and regulatory authorities, including SEC filings. In addition, consult with the examiner assigned Program 340, Oversight by the Board of Directors, to determine if review of the minutes reveals any items pertinent to the review of capital.

______________________________ ______________

2. Determine through discussions with management and other appropriate verification methods, if management has taken corrective action relative to:

   - Prior examination report comments and prior examination exceptions.
   - Internal and external audit exceptions.

Exam Date: ______________
Prepared By: ______________
Reviewed By: ______________
Docket #: ______________

Wkp. Ref.

- Any enforcement/supervisory actions and directives.

3. Obtain a copy of the thrift's worksheet for computing its minimum capital requirement pursuant to Schedule CCR of the TFR. Also, obtain related work papers and review for reliability. Determine whether the thrift is meeting its minimum capital requirements. Consider the prospects for continuing compliance by analyzing current trends and other factors.

   Some of the following areas may be material to the reliability of a thrift's capital requirement calculations:

   - Subsidiary activities
     - — is there evidence of permissibility of activities?
     - — is consolidation or pro rata consolidation correct for permissible subsidiaries?
     - — are nonincludable subsidiaries properly excluded or grandfathered and deducted on a pro rata basis?
     - — have advances to impermissible subsidiaries after April 12, 1989, been deducted from capital and assets as required?
     - — did the thrift and its subsidiary enter into a binding commitment prior to April 13, 1989, under which they were legally bound to make investments impermissible for national banks after April 13, 1989? If so, then the phase-out rule for nonincludable subsidiaries would apply to these investments after April 13, 1989.
     - — is the ownership percentage of a thrift's investment greater that 5%? If so, follow the capital treatment of subsidiaries.
   - If a minority interest of a third party is collateralized as stock, then is it excluded from Tangible Capital?
   - Are goodwill qualifications met?

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

— has goodwill created after April 12, 1989, been deducted from capital and assets?

— has goodwill created after April 12, 1989, been deducted from capital and assets?

- Are nonsubsidiary equity investments, nonresidential construction and land loans over 80% LTV, and reciprocal holdings of capital instruments properly excluded from Adjusted Total Capital in computing the association's Risk-Based Capital ratio.

- PMSR;

— are the three-part test results documented?

— is 90% FMV test done correctly?

— are prepayment assumptions reasonable?

— is the discount rate appropriate?

— are the write-downs timely?

— review for consistency with TB 60 (PMSR).

- Are other intangibles in Core Capital documented for the three-part test and within the allowable limit?

- Are LIP and commitments properly handled?

- Are GVA free of specific reserves?

- Are delinquent loans and REO properly risk weighted?

- Are high LTV loans properly risk weighted?

- Are maturing capital instruments properly handled?

- Are CMO tranches risk weighted per TB 38?

Exam Date: ______________________
Prepared By: ______________________
Reviewed By: ______________________
Docket #: ______________________

Wkp. Ref.

- Are assets sold with recourse properly treated?
  - — subordinated portions of senior subordinated securities?
  - — agreements by thrifts buy back loans (generally for a limited period) if they become delinquent or default for reasons other than violations of standard representations and warranties?
  - — recourse servicing sold?
- Are post-period-end adjustments correct?
- Are forbearances properly treated?
- Is capital charge on assets covered by the FDIC or SAIF properly applied?
- Are FSLIC- and FDIC-held capital instruments netted to related receivables when appropriate?

4. Determine whether the association is subject to any written agreements or capital plans or capital directive with the OTS, FDIC, or state authorities regarding capitalization, and whether the association is in compliance. Note specific areas of noncompliance in the ROE, as appropriate.

5. Evaluate trends in capital. Determine if management is adequately addressing adverse trends.

6. Evaluate the adequacy of capital.

   - Analyze how the thrift's balance sheet composition affects the need for capitalization. Consider the risk orientation of loan and investment portfolios. Consider risk diversification.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

- Analyze the risk associated with off-balance sheet activities and the resultant need for additional capital protection.

- Consider the thrift's growth trends and goals. Consider whether management has planned for capital adequacy in line with anticipated growth.

7. Consider the appropriateness of earnings retention and dividend policy.

8. If specific or general loss allowances are inadequate, determine the effect of current and potential losses. Confer with the examiners assigned Program 260, Classification of Assets, and Program 261, Valuation Allowances.

9. Consider the potential effect (positive or negative) of any proposed changes in controlling ownership.

10. Review management reports, such as the budget, strategic business plan, and capital plan to consider the adequacy of the thrift's capital planning efforts. Also, determine if capital projections appear reasonable given the thrift's risk posture.

11. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

12. Identify and reconcile capital accounts (forward from the date of the last examination) to determine propriety of entries and outstanding balances. Use existing external audit reports and SEC filings to the extent possible. Be alert for direct charges to capital

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

accounts that have not been properly recorded as part of the income statement.

13. Compare balances obtained in procedure 11 with the Thrift Financial Reports and management information systems to determine accuracy of reporting. Document discrepancies and review with management. If material problems are noted, prepare comments for the ROE.

14. Using available financial information, develop useful ratios for comparison with peer group averages or medians. Research any significant variations and determine if they are cause for concern.

15. Determine if the thrift is adequately protected against excessive exposure to interest-rate risk that might adversely affect capital. Confer with the examiner assigned Program 520, Interest-Rate-Risk Management and Program 530, Cash Flow and Liquidity Management.

16. Analyze the effect that service corporation and other subsidiary activities may have on the need for capitalization, including potential liability of the parent thrift for obligations of the subsidiary.

17. Analyze whether any holding company activities have an adverse effect on capital. Evaluate the parent's reliance on dividend payments from the subsidiary thrift. Review related SEC filings for transactions between the thrift and the holding company.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

18. Determine if deficiencies in internal controls and audit systems subject the thrift to a higher probability of losses through defalcations or fraud and thereby have an adverse effect on capital.

19. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Examiner's Summary, Recommendations, and Comments

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Risk-Weight Category Per § 567.6 of the Regulations

0% Risk Weight

Cash (any foreign currency owned and held by a thrift must be converted into U.S. dollar equivalents)

Securities issued by the U.S. Government and its agencies to the extent that such securities are unconditionally backed by the full faith and credit of the U.S. Government (e.g., Ginnie Maes)

Direct claims on the U.S. Government and its agencies to the extent that such claims are unconditionally backed by the full faith and credit of the U.S. Government

Securities and direct claims of the central government of an Organization for Economic Cooperation and Development (OECD) member country[1]

FSLIC notes and obligations backed by the full faith and credit of the U.S. Government

FDIC notes and obligations backed by the full faith and credit of the U.S. Government

Deposit reserves at, claims on, and balances due from Federal Reserve Banks

Federal Reserve Bank Stock

Portion of assets fully covered by FSLIC or any successor agency under capital loss and/or yield maintenance agreements

Portion of assets directly and unconditionally guaranteed by the U.S. Government, its agencies, or the central government of an OECD country

Certain credit equivalent amounts of off-balance-sheet items[2]

Accrued interest receivable on assets included in this category

20% Risk Weight

Cash items in process of collection

Portion of assets collateralized by the current market value of securities issued or guaranteed by the U.S. Government, its agencies, or the central government of an OECD country

Portion of assets conditionally guaranteed by the U.S. Government, its agencies, or the central government of an OECD country

Securities (not including equity securities) issued by the U.S. Government and its agencies that are not backed by the full faith and credit of the U.S. Government

Claims on the U.S. Government and its agencies that are not backed by the full faith and credit of the U.S. Government

Securities (not including equity securities) issued by U.S. Government-sponsored agencies (e.g., Federal Home Loan Mortgage Corporation, Federal National Mortgage Association)

Direct claims on U.S. Government-sponsored agencies

Portion of assets guaranteed by U.S. Government-sponsored agencies (e.g., Federal Home Loan Mortgage Corporation, Federal National Mortgage Association)

Portion of assets collateralized by the current market value of securities issued or guaranteed by U.S. Government-sponsored agencies (e.g., Federal Home Loan Mortgage Corporation, Federal National Mortgage Corporation)

High-quality mortgage-related securities (including CMOs), except for those with residual characteristics or stripped mortgage-related securities

Claims representing general obligations of any public sector entity in an OECD country, and that portion of any claims guaranteed by any such public entity

Bonds issued by the Financing Corporation or the Resolution Funding Corporation

Balances due from and all claims on domestic depository institutions. This includes demand deposits and other transaction accounts, savings deposits and time certificates of deposit, federal funds sold, loans to other depository institutions, including overdrafts and term federal funds, holdings of the thrift's own discounted acceptances for which the account party is a depository institution, holdings of bankers acceptances of other institutions and securities issued by depository institutions, except those that qualify as capital.

Federal Home Loan Bank Stock

Deposit reserves at, claims on, and balances due from Federal Home Loan Banks

Assets collateralized by cash held in a segregated deposit account by the reporting thrift

Claims on, or guaranteed by, official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member. These institutions include, but are not limited to, the: International Bank for Reconstruction and Development (World Bank), Inter-American Development Bank, Asian Development Bank, African Development Bank, European Investments Bank, International Monetary Fund, and the Bank for International Settlements.

Portion of assets collateralized by the current market value of securities issued by official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member

Claims on depository institutions incorporated in an OECD country, and assets backed by the full faith and credit of depository institutions incorporated in an OECD country. This includes the credit-equivalent amount of participations in commitments and standby letters of credit sold to other depository institutions incorporated in an OECD country, but only if the originating bank remains liable to the customer or beneficiary for the full amount of the commitment or standby letter of credit. Also included in this category are the credit-equivalent amounts of risk participations in bankers' acceptances conveyed to other depository institutions incorporated in an OECD country. However, bank-issued securities that qualify as capital of the issuing bank are not included in this category.

Claims on depository institutions incorporated in a non-OECD country, as well as claims on the central bank of a non-OECD country, with a residual maturity of one year or less

Certain ownership interests in investment companies[3]

Certain credit-equivalent amounts of off-balance-sheet items[2]

Accrued interest receivable on assets included in this category

50% Risk Weight

Revenue bonds, issued by any public sector entity in an OECD country, for which the underlying obligor is a public sector entity, but that are repayable solely from the revenues generated from the project financed through the issuance of the obligations

Qualifying mortgage loans (one- to four-family residential first mortgage loans that are prudently underwritten and performing, not more than 90 days past due, with a loan-to-value ratio not exceeding 80% [at origination] unless insured to at least 80% by an FHLMC- or FNMA-approved private mortgage insurer). Loans paid down to 80% LTV are included if otherwise qualifying. Loans to individuals for the construction of their homes.

Qualifying residential construction loans as defined in 12 C.F.R. 567.1(jj)

Qualifying multifamily mortgage loans as defined in 12 CFR § 567.1(v).

Less-than-high-quality mortgage-related securities backed by qualifying mortgage loans, except for those with residual characteristics or stripped mortgage-related securities. Non-high quality stripped MBS will be placed in this category upon effectiveness of the interest-rate-risk component (July 1, 1994).

Certain ownership interests in investment companies[3]

Certain credit equivalent amounts of off-balance-sheet items[2]

Accrued interest receivable on assets included in this category

100% Risk Weight

Consumer loans

Commercial loans

Home equity loans (second mortgages - placed in 50% risk weight if secured by a first lien and meets all other qualifying criteria)

Nonqualifying mortgage loans

Nonqualifying multifamily mortgage loans

Residential construction loans

Land loans (except portions in excess of 80% loan-to-value ratio)

Portion of land loans with loan-to-value ratios in excess of 80% that are includable in assets under the phase-out provisions

Nonresidential construction loans (except portions in excess of 80% loan-to-value ratio)

Portion of nonresidential construction loans with loan-to-value ratios in excess of 80% that are includable in assets under the phase-out provisions

Mixed use commercial loans (one- to four-family residential or multifamily residential and commercial properties)

Obligations issued by any state or any political subdivision thereof for the benefit of a private party or enterprise where that party or enterprise, rather than the issuing state or political subdivision, is responsible for the timely payment of principal and interest on the obligations (industrial development bonds)

Private-issue debt securities, except those qualifying for the 20% risk-weight category or the 50% risk-weight category

Fixed assets and premises

Prepaid insurance

Intangible Assets, including any goodwill not deducted from capital

Purchased and excess mortgage servicing rights

Any classes of a mortgage-related security with residual characteristics, as defined in Thrift Bulletin 38, regardless of the issuer or guarantor (CMO and REMIC residuals)

Equity investments not subject to deduction because permissible for a national bank

Prorated assets of subsidiaries (except for the assets of includable, fully consolidated subsidiaries) to the extent such assets are included in adjusted total assets

Mortgage-backed bonds collateralized by second mortgages

Tax certificates

Certain ownership interests in investment companies[3]

Certain credit equivalent amounts of off-balance-sheet items[2]

Accrued interest receivable on assets included in this category

Repossessed assets

Assets that are more than 90 days past due (including delinquent one-to four-family mortgage loans and multifamily mortgage loans)

All assets not specifically included in any other risk-weight category

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[1]The OECD includes the following countries: Australia, Austria, Belgium, Canada, Denmark, Federal Republic of Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States. Saudi Arabia has con-

cluded special lending arrangements with the International Monetary Fund associated with the Fund's General Arrangements to Borrow and is treated as an OECD country.

[2] Off-balance-sheet items that have been credit converted are classified in risk-weight categories based on the type of asset involved or the counterparty to the transaction, whichever is more appropriate.

[3] Ownership interests in investment companies as defined in the Investment Company Act of 1940 are assigned to risk-weight categories based upon the risk weight that would be assigned to the assets in the portfolio of the investment company. If the portfolio would fall into more than one risk-weight category or contains some assets that would be deducted from capital, the entire ownership interest will be assigned to the category of the asset with the highest risk weight in the portfolio or included in Assets Required to be Deducted in the calculations of Adjusted Total Capital.

The lowest risk-weight category for a mutual fund is 20%. On a case-by-case basis, however, the OTS may allow the thrift to assign the portfolio proportionately to the various risk categories based on the proportion in which the risk categories are represented by the composition of assets in the portfolio. Before OTS will consider a request to proportionately risk weight such a portfolio, the thrift must have and maintain current information for the reporting period that details the composition of the portfolio of assets.

FDICIA CATEGORIES FOR PROMPT CORRECTIVE ACTION

	Total Risk-Based Ratio		Tier 1 (Core) Risk-Based Ratio		Tier 1 (Core) Leverage Ratio	Capital-Related Action
Well-Capitalized	10% or above	&	6% or above	&	5% or above	Not subject to capital directive or capital-related cease and desist order
Adequately Capitalized	8% or above	&	4% or above	&	4% or above[1]	
Undercapitalized	Under 8%	or	Under 4%	or	Under 4%[2]	
Significantly Undercapitalized	Under 6%	or	Under 3%	or	Under 3%	
Critically Undercapitalized	Ratio of tangible equity to adjusted total assets of 2% or less[3]					

Following are the formulas for the above capital measures:

1. Total Risk-based Ratio = CCR 39/CCR 65[4]
2. Tier 1 (Core) Risk-Based Ratio = CCR 20/CCR 65[4]
3. Tier 1 (Core) Leverage Ratio = CCR 20/CCR 25
4. Tangible Equity Ratio = ((CCR 225 - CCR 220 -CCR 230 + SC 812/(CCR 25 - CCR 250))

[1] Three percent (3%) or above for composite 1-rated banks and savings associations.

[2] Under three percent (3%) for composite 1-rated banks and savings associations.

[3] Tangible equity is defined as core capital elements plus cumulative perpetual preferred stock minus all intangible assets except for qualifying purchased mortgage servicing rights and (for savings associations) remaining qualifying supervisory goodwill. Total assets is defined (for savings associations) to be adjusted total assets minus nonqualifying intangible assets.

[4] If an association has fully capitalized items reported on CCR 70, the association should modify this ratio by electing to either (1) deduct the amount of fully capitalized items from the capital amount in the numerator of the ratio or (2) increase the asset amount in the denominator of this ratio by the fully capitalized amount on CCR 70 multiplied by 12.5 (i.e., CCR 70 * 12.5).

Prompt Corrective Action Restrictions		
Financial Health	**FDICIA Restrictions**	**Applicable Guidance**
Well-capitalized	*Cannot pay dividends or management fees to controlling persons if it would result in undercapitalization	12 CFR § 563.134
Adequately Capitalized	*Cannot pay dividends or management fees to controlling persons if it would result in undercapitalization	12 CFR § 563.134
Undercapitalized	*Cannot pay dividends or mgmt. fees to controlling persons *Monitoring of condition and capital plan required *Capital Plan required (copy of approved plans to FDIC) *Asset Growth Restricted *Prior approval required for acquisitions, branching, new lines of business	12 CFR § 563.134 TB 36b TB 36b RB 3a-1 12 CFR Part 516
Significantly Undercapitalized	(In addition to restrictions for Undercapitalized institutions) #Require recapitalization by issuing stock or acquisition #Restrict interest rates (not retroactive) #Restrict Transactions With Affiliates Restrict asset growth (or require shrinkage) Restrict risky activities of association or subsidiary Improve management: • order new election of the board of directors • dismiss directors or senior executive officers • require employment of qualified senior executive officers Prohibit deposits from correspondent banks Require Divestiture: • by the institution of any subsidiary • by the parent company of a nondepository affiliate of the institution Any other action the AFBA determines is necessary *Prior approval from the AFBA for: • payment of any bonus to a senior executive officer • increase in compensation for senior executive officers	 Brokered Deposits (FDIC 12 CFR § 337.6) 12 CFR § 563.41 RB 3a-1 Interbank Liabilities (FRB 12 CFR Part 206) 12 CFR § 565.6
Critically Undercapitalized	*Prior FDIC approval required for activities: • material transactions • extensions of credit for HLTs • amendment of charter of bylaws • engaging in covered transactions (23A) • payment of excessive compensation or bonuses • payment of interest rates > normal market rates • payments on subordinated debt Within 90 days AFBA must appoint Receiver, Conservator, or take other action pursuant to Section 38	 Brokered Deposits (FDIC 12 CFR § 337.6)

*Automatic restrictions

The agency must take these actions unless the agency determines that the actions would not further the purpose of §38.